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No. —

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Supreme Court of t
OCTOBER TE

THOMAS E. BENNETT,
THEODORE BLACK and

v.

COMMISSIONER OF INT

On Petition for a Writ o
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DAN A. BENNETT,
MARILYN BLACK,
Petitioners,

ERNAL REVENUE,
Respondent.

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Certiorari to the
of Appeals
Circuit

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RT A. SMITH *
Madison Avenue
York, New York 10022
759-8285
ney for Petitioners
nsel of Record

096 - WASHINGTON, D.C. 20001

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QUESTION PRESENTED

Whether the penalty prescribed by Section 6653(a) of the Internal Revenue Code for negligence can be imposed where the taxpayer's returns were prepared in good faith reliance upon the opinions of a reputable law firm and an officer of a major bank and its tax department, on the ground that these advisers were not expert in the particular technology underlying the taxpayer's investment.

LIST OF PARTIES

The only parties to this proceeding are Thomas E. Bennett, Joan A. Bennett, Theodore Black, Marilyn Black, and the Commissioner of Internal Revenue.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

No. ———

THOMAS E. BENNETT, JOAN A. BENNETT,
THEODORE BLACK and MARILYN BLACK,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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PETITION FOR A WRIT OF CERTIORARI

Thomas E. Bennett, Joan A. Bennett, Theodore Black, and Marilyn Black hereby petition for a writ of certiorari to review the judgments of the United States Court of Appeals for the Second Circuit in these cases.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, pp. 1a-2a) is not officially reported. The memorandum findings of fact and opinion of the Tax Court (App., *infra*, pp. 3a-32a) are not officially reported.

JURISDICTION

The judgments of the court of appeals were entered on December 26, 1997 (App., *infra*, 1a-2a). By order dated March 10, 1998, Justice Ginsburg extended the time

within which a petition for a writ of certiorari could be filed to and including April 27, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

The provisions of Section 6653(a) of the Internal Revenue Code of 1986 (26 U.S.C.) are set forth at App., *infra*, pp. 37a-38a.

STATEMENT

During 1981, petitioners [1] invested in a limited partnership that leased machines designed to recycle styrofoam scrap material into pellets that could be used to manufacture recycled plastic. On their tax return for that year, petitioners claimed the investment tax and business energy credits in reliance upon an opinion of a distinguished tax lawyer, and in further reliance upon the investigatory work of an officer of a major bank and its tax department, which independently confirmed the conclusions of the lawyer's opinion. Despite petitioners' reliance upon such independent advice from professionals attached to established institutions with which they had longstanding relationships, the decision below held that petitioners were liable for the negligence penalty because their advisers were not experts in the particular technology underlying petitioners' investment.

The pertinent facts can be summarized as follows: During the taxable year at issue (1981), petitioners were senior executives with Ingersoll Rand, where they had spent their entire life-long careers. The Chairman of Ingersoll Rand, William Wearly, was a member of the board of Bankers Trust. As a result, Bankers Trust had been retained by Wearly to provide financial counseling

[1] Unless otherwise indicated, references to the "petitioners" are to both Thomas E. Bennett and Theodore H. Black. Their wives, Joan Bennett and Marilyn F. Black, are parties to this proceeding solely because they filed joint returns with their husbands for the years at issue.

to the senior executives of his company (R. 183).[2] This program was undertaken because Wearly recognized that the arduous nature of the duties of his fellow officers left them little time to attend to their personal financial affairs (R. 175-76). Beginning in 1978, petitioner Bennett sought and received the advice of Bankers Trust with respect to estate planning and the ownership of insurance policies. In due course, the Bankers Trust officer who was responsible for the Ingersoll Rand account was Edward Gallagher, a vice president (R. 183-84).[3]

From time to time, Gallagher would recommend investment opportunities to the Ingersoll Rand executives. One of these investments involved a real estate opportunity sponsored by Daeske & Company. With respect to the Daeske opportunity, both Gallagher and Bankers Trust performed the necessary due diligence and positively recommended Daeske to the Ingersoll Rand executive group. After performing the necessary investigatory work, Gallagher considered himself qualified to introduce the Ingersoll Rand group to Daeske, even though he did not hold himself out to be an expert in real estate (R. 245-46). During his discussions with Gallagher, petitioner Bennett consistently emphasized his need for high quality investments. As a result, Gallagher recommended various real estate investments involving the Daeske organization

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[2] "R." references are to the joint appendix filed in the court of appeals.

[3] Gallagher was a member of Bankers Trust Company's personal financial planning department, which was established to work with bank customers in the areas of personal finances, estate planning, income tax planing, which was done through the bank's tax department, and retirement planning (R. 242-43). Gallagher had received special training for his assignment under the auspices af Bankers Trust Company. He had attended special programs within the bank itself, and participated in training administered by the American Institute of Banking. Moreover, when Bankers Trust established the financial planning program, Gallagher and his colleagues were trained by outside consultants (R. 243).

in which petitioner Bennett invested and earned substantial profits (R. 187).[4]

In early November 1981, Gallagher brought the Sentinel Recycler investment to the attention of petitioners Bennett and Black. As part of his investigation into the investment on behalf of the Ingersoll Rand group, petitioner Bennett held several long conversations with Gallagher with respect to the qualifications of the people involved in the investment. At petitioner Bennett's insistence, Gallagher made a special trip to Hyannis to inspect the equipment at the manufacturer's plant, and thereafter orally reported his finding to the Ingersoll Rand group (R. 189, 194). Gallagher told the group that the manufacturer of the recyclers, Packaging Industries, was a substantial going concern and confirmed its representations that it had been in business 40 years, that it commanded a 90 percent market share in blister packs, and that some of the major Fortune 500 industrial companies had ordered recyclers (*Id.*). Thereafter, Gallagher prepared a written report of his findings that he circulated to the Ingersoll Rand group of executives (R. 1091, 196-97).[5] In his report to the Ingersoll Rand group, Gallagher advised that the process of the Recycler was considered to be proprietary (R. 220-221). Petitioner Bennett therefore had no means available to confirm the accuracy of the representation by Packaging Industries to Gallagher that the machine was unique (R. 221). However, in light of his own professional experience, Bennett recognized that the price for such a proprietary machine turned principally on its economic benefit to the customer, rather than its cost of production (R. 222, 229).

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[4] Bennett also earned a substantial return on an investment in a cable television company that was recommended to him by Bankers Trust (R. 188-89).

[5] In his written report, Gallagher stated that he had observed the Recycler in operation and that the manufacturer's facilities were impressive and compared favorably with those of Ingersoll Rand (R. 1091).

As a result of their positions at Ingersoll Rand, Bennett and Black relied upon the work of the law firm of Windels, Marx, Davies & Ives. This New York City law firm was the principal law firm that Ingersoll Rand employed for general corporate matters relating to acquisitions, divestitures, contracts, etc. During their careers at Ingersoll Rand, both Bennett and Black had worked intensely with several of the partners at the Windels firm. As a result, they had a high regard for their integrity and found the Windels partners with whom they worked to be "very impressive people." (R. 198-99). The Windels law firm had been engaged to prepare the offering memorandum and tax opinion associated with the Recycler investment (R. 452).

Prior to making their investments, both Bennett and Black spent five or six hours reading the offering memorandum and comprehensive tax opinions of John Taggart, who was the senior tax partner of Windels Marx (R. 211, 316, 317, 331-332). Taggart was a well-known tax lawyer practicing with the Windels firm.[6] Taggart first learned of the Sentinel Recycler from Elliot Miller, a long-time friend, who was counsel to Packaging Industries, the manufacturer of the machine. Miller had asked the Windels firm if it would be interested in handling the tax and securities work in connection with an offering memorandum involving an investment in the Recyclers. After Taggart consulted with his colleagues, they concluded that it was something that should be further considered (R. 753).

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[6] Pursuant to stipulation, the testimony of John Taggart in *Provizer v. Commissioner*, 62 T.C.M. (CCH) 2531 (1992), *aff'd per curiam*, 996 F.2d 1216 (6th Cir. 1993), *cert. denied*, 510 U.S. 1163 (1994), is included in the record in these cases (R. 748). Taggart's professional credentials reflected a distinguished professional background. He had previously practiced at the law firm of White & Case, had served in the office of the Tax Legislative Counsel in the U.S. Treasury Department, and had been a full-time member of the faculty of New York University Law School and editor-in-chief of the Tax Law Review. In conjunction with his private practice, Taggart continued to be an adjunct member of the New York University law faculty (R. 749).

At the outset, Taggart undertook a thorough investigation of the investment. He did not wish to become associated with the transaction unless he was confident that the investment was legitimate and the value of the recyclers claimed by Packaging Industries was supportable (R. 754, 758). As part of his investigation, Taggart conferred with numerous people connected with the investment, including Miller (R. 756). In addition, Taggart reviewed a report on Packaging Industries prepared by Dun and Bradstreet (R. 754). Taggart also traveled to Hyannis, Massachusetts, where Packaging Industries' plant was located (R. 754, 757). Taggart toured Packaging Industries' facilities and inspected the Recycler in operation (R. 756-58). The officials at Packaging Industries represented to Taggart in writing that the recyclers were unique (R. 778). They also represented to Taggart in writing that the price for the recyclers was their fair market value and was equivalent to the price that Packaging Industries would charge to a third party. The price for the Recycler had been computed in accordance with the well-established method of measuring the stream of royalty income that the recyclers were expected to generate through the sale of pellets that would be converted into recycled plastic. Finally, Packaging Industries represented to Taggart that it would be able to place the recyclers with its existing customers for the procesing of expanded foam scrap material into pellets (R. 763).

As part of his due diligence, Taggart also researched the price of the pellet material that the recyclers produced (R. 761-62). In addition, Taggart consulted technical journals and used various other techniques to verify the uniqueness of the recyclers (R. 786-87). Although Taggart attempted to ascertain whether there was any other comparable recycler, he never could discover a competing machine (R. 778).

Taggart and other members of the Windels firm prepared the offering memorandum, tax opinion, and other

legal documents for Recycling Associates and numerous other similar transactions. In drafting these documents, Taggart was satisfied that he and his firm had performed sufficient due diligence with respect to the investment, that the price being paid for the recyclers was its fair market value, and that there was an appropriate market for the material produced by the recyclers. (R. 774, 778).[7]

The tax opinion prepared by Taggart (R. 565) was 67 pages long and thoroughly discussed all of the issues. After considering the facts and the applicable law, the opinion concluded that "There is little doubt that if questions are raised by the Internal Revenue Service with respect to these issues, they will be resolved in favor of the Partnership." Accordingly, the Windels firm opined that "it is substantially more likely than not that the tax results anticipated by the Partnership will be achieved." (R. 629).[8] After reading Taggart's opinion, petitioner

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[7] Included in the offering memorandum were two independent evaluators' reports that concluded that the price paid for the Recycler was fair and reasonable and that the Recycler was operationally reliable and capable of performing its task on a continuous basis (R. 638, 649). The first evaluator's report was written by Dr. Stanley M. Ulanoff, a Professor of Marketing at the School of Business of the City University of New York. Professor Ulanoff rendered his report after his own personal inspection of the Recycler at the Packaging Industries plant. He concluded that the quantity and quality of the pellets to be produced by the Recycler would produce sufficient royalties to the Partnership to establish that the price paid for the Recycler and the rent paid for it by the Partnership were fair and reasonable (R. 645-47). The second evaluator's report was written by Dr. Samuel Z. Burstein, a Professor of Mathematics at New York University. Professor Burstein had particular expertise in internal combustion engine research. Based upon his inspection of the Recycler and his discussions with the key personnel at Packaging Industries, Professor Burstein concluded that it would be operationally reliable and capable of effectively performing the task of polyethylene recycling on a continuous basis (R. 668).

[8] Gallagher emphasized Taggart's opinion in a written memorandum to the Ingersoll Rand group. Gallagher also assured the Inger-

Bennett concluded that it was "quite positive about the overall tax viability of the project." (R. 200). Moreover, Bennett and Black also knew that Gallagher met with Taggart to discuss the transaction and Bennett had read a memorandum of Gallagher describing his meeting with Taggart (R. 200, 318). Thereafter, Bennett met with Gallagher who verified the statements he made in his written memorandum (R. 201).

Petitioners Bennett and Black decided to invest in the plastics recycler partnership after carefully reading Taggart's tax opinion, which concluded that an investor could claim the tax benefits and that the partnership would withstand any Internal Revenue Service examination. They were particularly influenced by the fact that they and their colleagues had worked with several of the partners of the Windels firm and reposed great confidence in the firm, which they knew to be very conservative (R. 205). Moreover, Gallagher had advised Bennett that the Bankers Trust tax department had reviewed Taggart's opinion and had characterized it as "brilliant" (R. 205, 206, 208). Furthermore, Bennett had also read the opinions of the evaluators (see p. 7 n.7, *supra*) who were associated with well-known institutions and found them to be "very straightforward and very convincing." (R. 202). As a result of his reliance upon Taggart's positive opinion, its confirmation by the Bankers Trust tax department, the evaluators' reports, and Gallagher's written and oral reports, and his personal inspection of the recycler and its manufacturer, petitioner Bennett was not concerned that the Internal Revenue Service might challenge the value of the machine (R. 206). Accordingly, in full reliance on the panoply of professional due diligence, at the time Bennett claimed the tax benefits on his 1981 return associated with his investment in the plastics recycling part-

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soll Rand group that "[t]he Partnership has gone to great lengths to justify the valuation and viability of the Recycler." (R. 1097).

nership, he believed them to be entirely appropriate (R. 205-6, 208).

After carefully reviewing the offering memorandum and Taggart's opinion, the reports of the evaluators, and Gallagher's written reports that were prepared after he was sent by Bennett to conduct a personal inspection of the Recycler at the Packaging Industries plant, petitioner Black likewise concluded that the Recycler was priced appropriately by experienced professionals. Based upon the advice of counsel with whom Ingersoll Rand had a longstanding relationship and confirmed by the Bankers Trust tax department, Black also believed that the tax credits he claimed on his 1981 return associated with his plastics recycling investment were entirely appropriate (R. 323, 343).

The Decision Below. Despite petitioners' reliance upon: (1) the Taggart opinion and the record evidence of Taggart's due diligence; (2) the evaluators' reports; (3) the confirmation of the Taggart opinion by the Bankers Trust tax department; (4) the personal inspection of the machine and the manufacturer's plant by Taggart and a Bankers Trust officer; and (5) the representations to Taggart and Bankers Trust that the Recycler was unique, the Tax Court Special Trial Judge held that petitioners were negligent in claiming the tax benefits arising out of their investment in the partnership. In so holding, the Tax Court believed that the petitioners were negligent because their advisers were not experts in plastics recycling technology. In the Tax Court's view, petitioners were subject to the negligence penalty because they "did not independently investigate the . . . Recyclers [or] . . . hire an expert in plastics to evaluate the . . . transaction." (App., *infra*, p. 16a). In this respect, the Tax Court concluded that the petitioners could not reasonably rely upon due diligence of the Bankers Trust officer who investigated both the machinery and the manufacturer be-

cause he "possessed no special qualifications or professional skills in the recycling or plastics industries." (App., *infra*, p. 18a).

The court of appeals affirmed (App., *infra*, pp. 1a-2a). In a brief summary order, the court stated that it "agree[d] with the Tax Court's decision and affirm for substantially the reasons stated in Judge Dawson's opinion . . . (adopting and setting forth Special Trial Judge Wolfe's opinion)" (App., *infra*, p. 2a).

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals squarely conflicts with decisions of both the Fifth and Tenth Circuits with respect to the question whether the negligence penalty prescribed by Section 6653(a) of the Internal Revenue Code can be imposed when the taxpayer relies upon a tax adviser who is not expert in the technology underlying the investment that gave rise to the taxpayer's claimed tax benefits. These courts have held, in conformity with this Court's ruling in *United States v. Boyle*, 469 U.S. 241 (1985), that a taxpayer's reliance upon the tax advice of an accountant or attorney is sufficient to defeat the imposition of the negligence penalty. On the other hand, the decision below has upheld the Tax Court's holding that a taxpayer is subject to the negligence penalty unless he obtains the advice of an expert who is knowledgeable in the technology underlying the particular investment.

The question of statutory interpretation upon which this case turns has substantial administrative importance. There are thousands of persons throughout the country who have claimed tax benefits as a result of their participation in transactions that are virtually identical to the very investment involving the same equipment at issue in this case. The Commissioner has sought to impose the negligence penalty upon all of these similarly-situated taxpayers. This Court should therefore grant certiorari to

resolve the conflict among the various courts of appeals and establish a uniform national rule for the benefit of both taxpayers and the Internal Revenue Service.

1. Our income tax law depends upon a system of honest self-assessment. However, it is readily acknowledged that the complexity of the statute and the underlying rules and regulations require many individual taxpayers to seek professional advice with respect to their entitlement to various deductions and credits enacted by Congress to encourage certain investments. As a result, taxpayers frequently turn to advisers who provide their clients with guidance with respect to the tax consequences of particular investment activities and their qualification for certain tax benefits. Sometimes, however, the best and most thoughtful advice ultimately turns out not to have the expected result. In such a case, a taxpayer may be subject to adjustments and determinations of income tax deficiencies by the Internal Revenue Service. That is precisely what occurred in these cases. Relying upon the opinions of a reputable law firm and a major bank in which they reposed great confidence, the petitioners invested in widely-marketed limited partnerships and claimed various tax benefits on their 1981 returns. In 1992, after a sharply contested Tax Court trial in 1989 at which the conflicting opinions of experts were submitted, the same Tax Court Special Trial Judge who rendered the decisions below upheld the Commissioner's disallowances in a test case styled *Provizer v. Commissioner*, 63 T.C.M. (CCH) 2531 (1992), *aff'd per curiam*, 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994). The petitioners here, by stipulation, have conceded their ineligibility for the tax benefits they claimed. However, they seek review of the decision below that their conduct was negligent in 1982 at the time they filed their 1981 tax returns, even though they relied upon unquestionably competent professional tax advice.

The same Tax Court Special Trial Judge who decided the *Provizer* case and the decision below has thus far concluded in approximately 25 virtually identically-worded opinions that almost 50 other taxpayers who invested in similar partnerships were uniformly subject to the negligence penalty despite their reliance on various forms of professional advice. In this Tax Court judge's uniquely expansive and wholly unjustified reading of the negligence penalty, that penalty is applicable if neither the taxpayer nor his advisers are expert in the particular technology, which is the subject of the investment, *viz.*, plastics recycling. But that conclusion is fundamentally unsound and finds no support in the decisional law. To begin with, the negligence penalty is imposed upon conduct relating to the filing of an income tax return, and not, as the decision below would have it, upon the wisdom of the decision to make a particular investment.

At all events, the records in these cases are replete with evidence—which the Tax Court and the court of appeals totally disregarded—that petitioners' advisers did everything possible to confirm the reputation of the principals of the manufacturer of the machinery and the accuracy of the evaluation reports and financial projections that were made a part of the offering memorandum. They visited the factory, inspected the machinery in operation, took account of end-users who employed the machinery in their plants, undertook research in technical journals, and conferred with knowledgeable persons in the plastics industry. Petitioners' reliance upon their advisers' conclusions was therefore well placed.

In these circumstances, the law does not require that the adviser be expert in the particular technology underlying a transaction as long as he undertakes appropriate independent and conscientious investigation and makes those facts known to his client. If that is the case, the taxpayer's reliance upon the adviser is reasonable. Given

the due diligence of petitioners' advisers, which included the distinguished author of the tax opinion who was a member of a reputable law firm and the officer of a substantial bank with which petitioners had longstanding business relationships, the record demonstrates that they relied upon professional advice they reasonably believed to be competent in deciding to make their investment and to claim the tax benefits associated with it. There is accordingly no justification either in law or logic for the imposition of the negligence penalty in these cases.

2. a. When a taxpayer is charged with an underpayment that "is due to negligence or intentional disregard of rules or regulations . . .," Section 6653(a)(1) and (2) of the Code used to impose a penalty equal to 5 percent of the underpayment and 50 percent of the interest on such underpayments. See App., *infra*, pp. 37a-38a. Consistent with the reasonable man standard derived from the law of torts, the negligence penalty does not apply to a taxpayer who files his return in the same manner as a reasonable or ordinary and prudent person would do under the circumstances.

The classic and well-established course of conduct that has long been deemed sufficient to satisfy the reasonable care standard and thereby defeat the imposition of the negligence penalty is for a taxpayer to rely in good faith on the advice of a tax adviser. More than a decade ago in *United States v. Boyle*, 469 U.S. 241 (1985), this Court unanimously ratified the correctness of this rule and explained its rationale in the following terms:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code him-

> self would nullify the very purpose of seeking the advice of a presumed expert in the first place. "Ordinary business care and prudence" do not demand such actions.

469 U.S. at 251 (emphasis in original; citation omitted.)[9] The settled rule that good faith reliance on a tax adviser establishes the reasonableness of the taxpayer's conduct so as to reject the Commissioner's assertion of negligence is entirely appropriate. Indeed, in the absence of such a rule, only those taxpayers with the substantial time and ability necessary to investigate the tax consequences of particular investments themselves would be able to make such investments without fear of penalty. *Heasley v. Commissioner*, 902 F.2d 380, 383-384 (5th Cir. 1990).

b. The decision below is squarely in conflict with *Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995); and *Durrett v. Commissioner*, 71 F.3d 515 (5th Cir. 1996), as to which the Tax Court was apparently unaware and which the court of appeals declined to address in its opinion. In those cases, as here, the taxpayers invested in a similarly widely-marketed program. The particular program involved in those cases consisted of complex straddle transactions of forward contracts for government-backed financial securities known as First Western. Although the program promised various tax benefits, it was ultimately held to lack economic substance. Similarly, the taxpayers challenged only the Tax Court's conclusions that they were liable for the negligence penalty. As in these cases, the Tax Court rejected the taxpayers' reliance upon

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[9] Although *Boyle* dealt with the "reasonable cause" exception for non-filer penalties under Section 6651(a)(1) and held that the executor was personally responsible for timely filing of the estate tax return, the courts have uniformly invoked the passage set out above as a standard for measuring reasonable cause for purposes of the negligence penalty. *See, e.g., Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990); *Chamberlain v. Commissioner*, 66 F.3d 729, 733 (5th Cir. 1995); *Durrett v. Commissioner*, 71 F.3d 515 (5th Cir. 1996).

certified public accountants on the ground that the accountants had no specialized knowledge of securities transactions or straddles in forward contracts that were the heart of the First Western program (67 T.C.M. 2992, 2994; 67 T.C.M. 2735, 2742). However, relying upon this Court's teaching in *Boyle* that good faith reliance on professional advice concerning tax laws constitutes a defense against the negligence penalty, the Fifth Circuit unanimously reversed the Tax Court's finding of negligence in these two cases. As the Fifth Circuit flatly stated in *Chamberlain* (66 F.3d at 733; footnotes omitted):

> Taxpayers sought the advice of a tax expert about claiming the loss. The expert advised that there was "a good faith, supportable position" concerning the deductibility of the loss. The Tax Court erred in finding taxpayers negligent for claiming the loss. The record reflects no basis for a finding or conclusion that it was not reasonable for taxpayers to rely on the expert's advice. "To require the taxpayer to challenge the [expert], to seek a 'second opinion,' or to try to monitor [the expert] on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place." Because the taxpayers reasonably relied on the advice of a tax expert in claiming the loss, the negligence penalty should not have been imposed.

In *Durrett*, another panel of the Fifth Circuit applied precisely the same analysis in reversing the Tax Court's imposition of the negligence penalty against another taxpayer who invested in the same program.[10] There, the court observed as follows (71 F.3d at 518):

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[10] Although other circuits have upheld the negligence penalty against other First Western investors, those taxpayers relied upon unqualified advisers. *Freytag v. Commissioner*, 904 F.2d 1011 (5th Cir. 1990), *aff'd* on another ground, 501 U.S. 868 (1991) (adviser unaware of the facts); *Kozlowski v. Commissioner*, 70 F.3d 1279 (9th Cir. 1995), *aff'g* T.C. Memo 1993-430 (no showing adviser understood transaction and was qualified to give opinion); *Chakales v. Commissioner*, 79 F.3d 726 (8th Cir.), *cert. denied*, —— U.S.

> Here the Durretts sought professional advice from their attorney, a tax accountant, and the vice president of finance for the parent corporation of the subsidiary that employed Joseph Durrett. . . . We conclude that the record adequately establishes that it was reasonable for the Durretts to rely on the advice of these experts.

Moreover, the Tenth Circuit has likewise rejected the view adopted by the Tax Court and the court of appeals below that a taxpayer's reliance upon the advice of an expert is justified only if the expert is knowledgeable in the technology underlying the particular investment. In *Anderson v. Commissioner*, 62 F.3d 1266, 1271 (1995), after relying upon *Heasley, supra*, the Tenth Circuit concluded, albeit in *dictum*, that "one does not have to be an expert in an industry before he can invest in the industry himself or recommend an investment to another." That court therefore rejected the Tax Court's holding that the taxpayer was negligent in relying upon a tax expert who lacked knowledge and experience in the cargo container industry. Accord: *Mauerman v. Commissioner*, 22 F.3d 1001, 1006 (10th Cir. 1994); *Hildebrand v. Commissioner*, 28 F.3d 1024 (10th Cir. 1994), *aff'g, Krause v. Commissioner*, 99 T.C. 132 (1992).[11] Indeed, prior to the decision below in these and similar cases involving the

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——, 117 S.Ct. 85 (1996) (adviser relied on promoter of venture); *Foulds v. Commissioner*, 94 F.3d 651 (9th Cir. 1996) (adviser lacked tax expertise). Significantly, the Eighth Circuit in *Chakales* cited *Chamberlain* with approval. See 79 F.3d at 730.

[11] In *Anderson*, the Tenth Circuit ultimately affirmed the imposition of the negligence penalty on the ground that the taxpayer was negligent in signing a substantial promissory recourse note to finance his purchase of the containers without confirming that the containers actually existed. The court concluded that had the taxpayer conducted a reasonable investigation, he would have learned that the program was a sham and that the containers did not exist. 62 F.3d at 1272. These unique facts are not present in the instant cases where the taxpayers did not sign a promissory note and the recyclers unquestionably existed and functioned effectively.

same investment that have been consistently decided in favor of the Commissioner in 25 virtually identically-worded opinions by the same Tax Court Special Trial Judge, it was generally understood under the teaching of *Boyle* that a taxpayer could reasonably rely upon the judgment of a competent tax adviser who undertook a conscientious investigation of the proposed investment.

Thus, as matters now stand, the courts of appeals are in disarray with respect to the application of this Court's *Boyle* standard where a taxpayer relies upon an attorney or tax adviser who is not an expert in the technology underlying the taxpayer's investment. If petitioners were resident in the Fifth or Tenth Circuit, rather than in the Second Circuit,[12] they would have been able to defeat the imposition of the negligence penalty. In the absence of a decision by this Court resolving the conflict among the court of appeals, the treatment afforded to similarly-situated taxpayers will vary based solely upon geographic happenstance. Review by this Court is warranted to avoid continuing uncertainty and disparate application of the revenue laws.

3. The question presented has substantial and continuing importance. While Section 6653(a) as originally enacted in the Economic Recovery Tax Act of 1981 has been repealed by the Omnibus Budget Reconciliation Act of 1989, the critical statutory language penalizing "the portion of any underpayment which is attributable to . . . "[n]egligence" continues to be employed in the new accuracy-related penalty provision of Section 6662(b)(1) and (c) of the Code. Moreover, the Commissioner has publicly acknowledged in his brief to the Sixth Circuit in the *Provizer* case that approximately 2,500 tax returns

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[12] In a non-precedential summary order, the Eleventh Circuit recently affirmed the Tax Court's imposition of the negligence penalty against a taxpayer who invested in a plastics recycling partnership. *Morgan v. Commissioner*, No. 97-4599, decided March 9, 1998.

claimed precisely the same tax benefits that are affected by the decision below for the tax years 1981 and 1982. If we conservatively assume that approximately 2,000 taxpayers invested an average of $12,500 in identical transactions, the negligence penalties against these taxpayers would total approximately $170 million.[13] Given the Commissioner's expansive reading of the negligence penalty in these cases and in other transactions,[14] it is fair to assume that there are many other cases presenting this question that are pending administratively and in the courts. As this Court pointedly observed in *United States v. Boyle, supra,* 469 U.S. at 248, "We need not dwell on the similarities or differences in the facts presented by the conflicting holdings. The time has come for a rule with as 'bright' a line as can be drawn consistent with the statute and implementing regulations (footnote omitted)." Here, too, review by this Court is likewise amply justified.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

STUART A. SMITH *
551 Madison Avenue
New York, New York 10022
(212) 759-8285
Attorney for Petitioners

April 1998.

* Counsel of Record

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[13] We calculate this figure in the following manner: The investment of $12,500 in the transaction at issue resulted in the determination of an income tax deficiency of $31,366. Extrapolating a total nationwide dollar investment of $25 million (2,000 × $12,500), the negligence penalty amount would be equal to the sum of 5 percent of the total deficiencies ($3,136,600) plus $170,646,000. The latter figure represents 50% of the interest accruing in these cases from April 15, 1982, to December 31, 1997.

[14] See, *e.g., Greene v. Commissioner,* 75 T.C.M. 1967 (1998).

APPENDIX A

[Filed Dec. 26, 1997]

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 26th day of December, one thousand nine hundred and ninety-seven.

Present: HONORABLE RALPH K. WINTER,
Chief Judge,
HONORABLE JON O. NEWMAN,
HONORABLE J. CLIFFORD WALLACE,*
Circuit Judges.

Nos. 96-4135(L),
96-4136(CON)

THOMAS E. BENNETT, JOAN A. BENNETT,
THEODORE BLACK and MARILYN BLACK,
Petitioners-Appellants,

-v.-

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

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* The Honorable J. Clifford Wallace, of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

SUMMARY ORDER

Appeal from the United States Tax Court (Dawson, *Judge*).

This cause came on to be heard on the transcript of record from the United States Tax Court and was argued.

ON CONSIDERATION WHEREOF, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the judgment of the Tax Court is hereby affirmed.

Thomas E. Bennett, Joan A. Bennett, Theodore Black, and Marilyn Black appeal from a decision by Judge Dawson that adopted the opinion of Special Trial Judge Wolfe which, in part, imposed penalties on appellants pursuant to Internal Revenue Code §§ 6653(a) and 6659. On appeal, the Bennetts and Blacks challenge the imposition of these penalties. We agree with the Tax Court's decision and affirm for substantially the reasons stated in Judge Dawson's opinion. *See Bennett v. Commissioner*, 71 T.C.M. (CCH) 1737 (1996) (adopting and setting forth Special Trial Judge Wolfe's opinion).

FOR THE COURT:

GEORGE LANGE, III
Clerk

/s/ Lucille Carr
By:

December 26, 1997
Date

APPENDIX B

T.C. Memo. 1996-14

UNITED STATES TAX COURT

Docket Nos. 31758-85, 36202-86

THOMAS E. AND JOAN A. BENNETT,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

THEODORE H. AND MARILYN F. BLACK,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Filed January 22, 1996

MEMORANDUM FINDINGS OF FACT AND OPINION

DAWSON, *Judge*: These consolidated cases were assigned to Special Trial Judge Norman H. Wolfe pursuant to the provisions of section 7443A(b)(4) and Rules 180, 181, and 183.[1] They were tried and briefed separately but consolidated for purposes of opinion. The Court

[1] All section references are to the Internal Revenue Code, in effect for the years in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

agrees with and adopts the opinion of the Special Trial Judge, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

WOLFE, *Special Trial Judge*: These cases are part of the Plastics Recycling group of cases. For a detailed discussion of the transactions involved in the Plastics Recycling cases, see *Provizer v. Commissioner*, T.C. Memo. 1992-177, affd. without published opinion 996 F.2d 1216 (6th Cir. 1993). The underlying transaction in these cases is substantially identical to the transaction considered in the *Provizer* case.

In a notice of deficiency, respondent determined deficiencies in the 1978, 1979, and 1981 joint Federal income taxes of petitioners Bennett in the respective amounts of $19,120, $954, and $37,715.[2] Respondent also determined that interest on deficiencies accruing after December 31, 1984, would be calculated at 120 percent of the statutory rate under section 6621(c).[3] In an amendment to answer, respondent asserted the following: For taxable years 1978 and 1979, additions to tax for negligence under section 6653(a); for taxable years 1978, 1979, and 1981, additions to tax for valuation overstatement under

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[2] The deficiencies in the Bennett case, Docket No. 31758-85, for taxable years 1978 and 1979 result from disallowance of investment tax credit carrybacks and business energy credit carrybacks from taxable year 1981.

[3] The notice of deficiency refers to sec. 6621(d). This section was redesignated as sec. 6621(c) by sec. 1511(c)(1)(A) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2744 and repealed by sec. 7721(b) of the Omnibus Budget Reconcilation Act of 1989 (OBRA 89), Pub. L. 101-239, 103 Stat. 2106, 2399, effective for tax returns due after Dec. 31, 1989, OBRA 89 sec. 7721(d), 103 Stat. 2400. The repeal does not affect the instant case. For simplicity, we will refer to this section as sec. 6621(c). The annual rate of interest under sec. 6621(c) for interest accruing after Dec. 31, 1984, equals 120 percent of the interest payable under sec. 6601 with respect to any substantial underpayment attributable to tax-motivated transactions.

section 6659; and for taxable year 1981, additions to tax under section 6653(a)(1) for negligence and under section 6653(a)(2) in an amount equal to 50 percent of the interest due on the underpayment attributable to negligence.[4]

In a notice of deficiency, respondent determined a deficiency with respect to the joint Federal income tax return filed by petitioners Black for 1981 in the amount of $74,111. Respondent also determined additions to tax in the amount of $7,411 under section 6661, in the amount of $3,705 under section 6653(a)(1) for negligence, and under section 6653(a)(2) in an amount equal to 50 percent of the interest due on the underpayment attributable to negligence. In an answer to petition, respondent asserted that interest on deficiencies accruing after December 31, 1984, would be calculated at 120 percent of the statutory rate under section 6621(c). See *supra* note 3. In an amendment to answer, respondent asserted an addition to tax under section 6659 for taxable year 1981. See *supra* note 4.

Petitioners each filed a Stipulation of Settled Issues relating to their participation in the "Plastics Recycling Program" and the additions to tax relating thereto. The parties stipulated that petitioners Bennett and Black are not entitled to any deductions, losses, investment tax credits, business energy credits, or any other tax benefits claimed on their tax returns as a result of their participation in the "Plastics Recycling Program". The parties further stipulated that the underpayments in income tax attributable to petitioners' participation in the "Plastics Recycling Program" are substantial underpayments attributable to tax motivated transactions, subject to the increased rate of interest established under section 6621(c).

Respondent and petitioners Bennett also filed a stipulation of settled issues with respect to tax benefits claimed

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[4] Corresponding dollar figures were not set out by respondent for these asserted additions to tax.

in 1981 flowing from their interests in three other limited partnerships not at issue herein: Ludlow Oil & Gas Drilling Program 1980, Monroe Oil & Gas Drilling Program 1980 Ltd., and Riefenberger No. 1 1981 Ltd.

Respondent's determination of an addition to tax under section 6661 with respect to petitioners Black was not specifically addressed in the stipulation of settled issues nor elsewhere in the record. However, the third stipulation in the stipulation of settled issues provides:

> This stipulation [of settled issues] resolves all issues that relate to the items claimed on petitioners' tax returns resulting from their participation in the Plastics Recycling Program, with the exception of petitioners' potential liability for additions to the tax for valuation overstatements under I.R.C. § 6659 and for negligence under the applicable provisions of I.R.C. § 6653(a).

Because of this stipulation, we consider any issue with respect to the addition to tax under section 6661 to be settled.

The issues for decision in these consolidated cases are: (1) Whether petitioners are liable for additions to tax for negligence or intentional disregard of rules or regulations under section 6653(a); and (2) whether petitioners are liable for the addition to tax under section 6659 for an underpayment of tax attributable to valuation overstatement.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulated facts and attached exhibits are incorporated by this reference. Petitioners Bennett resided in Avon, Connecticut, when their petition was filed. Petitioners Black resided in New Canaan, Connecticut, when their petition was filed.

During 1981, Thomas E. Bennett (Bennett) was a vice president at Ingersoll-Rand Company (Ingersoll-Rand). His spouse, Joan A. Bennett, was not employed outside the home. Theodore H. Black (Black) was also a vice president of Ingersoll-Rand during 1981. His wife, Marilyn F. Black, was not employed outside the home.

For their respective investments of $25,000, petitioners Bennett and Black each acquired a 2.605-percent interest in the limited partnership Empire Associates (Empire) during 1981. As a result of the passthrough from Empire, on their respective 1981 Federal income tax returns petitioners each deducted an operating loss in the amount of $20,510 and claimed investment tax credits in the amount of $42,402. Petitioners Bennett used $22,328 of the claimed credits on their 1981 return and carried back the unused portion of the credits to 1978 and 1979 in the respective amounts of $19,120 and $954. Respondent disallowed petitioners' claimed deductions and credits related to Empire. In docket No. 31758-85, respondent disallowed petitioners Bennett's claimed deductions related to three previously mentioned partnerships not at issue herein.

The facts of the underlying transaction in these cases are substantially identical to those in *Provizer v. Commissioner*, T.C. Memo. 1992-177, and may be summarized as follows. In 1981, Packaging Industries, Inc. (PI), manufactured and sold seven Sentinel expanded polyethylene (EPE) recyclers to ECI Corp. for $6,867,000 ($981,000 each), of which $533,000 was paid in cash. ECI Corp., in turn, resold the recyclers to F & G Corp. for $8,138,667 ($1,162,666 each), of which $618,000 was paid in cash. F & G Corp. then leased the recyclers to Empire, which licensed the recyclers to FMEC Corp., which sublicensed them back to PI. All of the monthly payments required among the entities in the above transactions offset each other. These transactions were accom-

plished simultaneously. We refer to these transactions collectively as the Empire transaction.

In *Provizer v. Commissioner, supra,* we examined the Clearwater transaction. In the Clearwater transaction, PI sold six EPE recyclers to ECI Corp. for $981,000 each, and ECI, in turn, resold the recyclers to F & G Corp. for $1,162,666 each. F & G leased the recyclers to a limited partnership, Clearwater, which licensed them to FMEC, which sublicensed them to PI. The transaction involved herein differs in two respects: (1) Seven Sentinel EPE recyclers were sold and leased rather than six; and (2) Empire, rather than Clearwater, leased the recyclers from F & G and then licensed them to FMEC. Empire is therefore like Clearwater, occupying the same link in the transactional chain. The Sentinel EPE recyclers considered in these cases are the same type of machines considered in the *Provizer* case. The fair market value of a Sentinel EPE recycler in 1981 was not in excess of $50,000.

PI allegedly sublicensed the recyclers to entities that would use them to recycle plastic scrap. The sublicense agreements provided that the end-users would transfer to PI 100 percent of the recycled scrap in exchange for a payment from FMEC Corp. based on the quality and amount of recycled scrap.

Bennett and Black each learned of the Empire transaction from Edward Gallagher (Gallagher). Gallagher was an officer in the personal financial planning department at Bankers Trust. Ingersoll-Rand had retained Bankers Trust in the early 1970's to provide financial counseling to its officers. Gallagher became responsible for the Ingersoll-Rand account starting in the late 1970's and counseled executives on investment planning, estate planning, income tax plainning, and retirement planning. Gallagher had been with Bankers Trust since 1964. Before then he had earned a B.A. degree from Holy Cross

College in 1962, spent a year in medical school, and served in the U.S. Army.

Gallagher learned of the Empire transaction from Robert Miller (Miller), a lawyer at the firm of Windels, Marx, Davies & Ives (WMDI). Ingersoll-Rand was a client of WMDI. Miller referred Gallagher to John Taggart (Taggart), the head of the tax department at WMDI. Gallagher discussed the transaction with Taggart and the general partner of Empire, Richard Roberts (Roberts). Gallagher read the offering memorandum and used that information to analyze the economics of the investment. Gus Kreischer (Kreischer), who was in charge of the tax section of the trust department at Bankers Trust, reviewed WMDI's tax opinion letter contained in the offering memorandum and reported favorably to Gallagher with respect to the opinion.

Gallagher discussed the Sentinel EPE recycler transactions with about 11 executives at Ingersoll-Rand. At the behest of Bennett, Gallagher toured PI's Hyannis plant. Upon his return from Hyannis, Gallagher reported to the officers at Ingersoll-Rand and told them that PI was a going concern, that he had seen the recyclers, and that they were big machines. Gallagher also submitted a brief handwritten summary to the same effect. He prefaced his written summary by noting that he did "not have an engineering background." The summary included a list of six purported current end-users of recyclers and contained the following postscript: "If you have any questions or would like an opportunity to see the equipment in operation, please let me know." Gallagher made no representations about the uniqueness of the recyclers.

Neither Gallagher nor Bankers Trust received a commission from Ingersoll-Rand for the investments in the Plastics Recycling transactions. However, Gallagher did receive what he admitted was a "special deal." The typical Plastics Recycling investment entailed the acquisition

of an interest in a partnership which leased the recyclers. Such an interest sold for a minimum of $50,000. In December of 1981, however, Gallagher was allowed to purchase a 10-percent undivided interest directly in a recycler, for which he paid approximately $10,000 in cash and $90,000 in notes. Gallagher told representatives of Bankers Trust and also Bennett and probably Black that he was receiving this special deal.

Bennett is a graduate of the New York State Maritime Academy, from which he received a degree in marine engineering in 1950. After graduation he tested for a Coast Guard license and was qualified to operate any ship as a third assistant engineer. Bennett began working for Ingersoll-Rand in the fall of 1951. Bennett started as an applications engineer in the centrifugal pump marketing department where he was responsible for working on worldwide customer inquiries, and was a specialist on power plants and marine and navy equipment. From 1951 to 1968 he served in a marketing capacity and continuously dealt with product pricing. During 1972 he completed an advanced management program at Harvard University. By 1978 he had been promoted to vice president in charge of strategic planning, and became involved in the planning for all of the businesses and also mergers and acquisition analysis and studies. In mid-1981 he was reassigned to the Torrington Company, an Ingersoll-Rand subsidiary located in Torrington, Connecticut, which manufactured roller bearings.

As an officer of Ingersoll-Rand, Bennett received financial counseling from Bankers Trust. The Bankers Trust representative during 1981, Gallagher, told him about Empire. Bennett reviewed the Empire offering memorandum and discussed the investment with Gallagher and with other Ingersoll-Rand executives. Bennett insisted that Gallagher visit the PI plant and see the recyclers. Gallagher did so and reported back to the executives. Bennett knew Gallagher was not an engineer and "could

not assess the machine in terms of its technical capability." Gallagher arranged for the general partner of Empire, Roberts, to meet with the officers at the Ingersoll-Rand corporate headquarters. Bennett did not attend that meeting.

Ingersoll-Rand manufactures machinery, including construction equipment, pumps, air compressors, rock drills, pneumatic tools, and bearings. Its 1993 revenues were slightly more than $4 billion. One of Ingersoll-Rand's subsidiaries during 1981, Improved Machinery Company (IMCO), manufactured plastic injection molding equipment. Bennett was aware of IMCO and the nature of its business in 1981. He had been to the IMCO plant several times and knew that IMCO's injection molding machine used pellets, probably the same type produced by the Sentinel EPE recycler. Bennett did not, however, talk to anyone at IMCO about the Empire transaction or the Sentinel EPE recycler prior to making his investment in Empire. Bennett knew that several recyclers purportedly had been placed with end-users before he invested in Empire. However, Bennett did not see a Sentinel EPE recycler prior to investing in Empire, nor did he investigate whether there were any existing or potential competitors for the Sentinel EPE recycler.

Black joined the U.S. Marine Corps. at the nd of 1945. In 1949 he entered the U.S. Naval Academy, and in 1953 he graduated with a bachelor of science degree in electrical engineering. Black began his career at Ingersoll-Rand in 1957. Over the course of his career, Black held the positions of salesman, technical personnel director, account manager, general manager, district manager, president, and chairman and chief executive officer. As general manager of the turbo products division in 1967, he first became responsible for pricing specially engineered equipment with unique proprietary technology. In the fall of 1974, Black attended an advanced management program at Harvard University.

Black first heard of the Sentinel EPE recyclers from Gallagher in 1981. He had no formal education, training, or background in chemical engineering, plastics engineering, or plastics processing, although he had substantial knowledge of some plastics processing from the standpoint of the seller of machinery. His investigation of the Empire transaction did not extend beyond discussions with Gallagher and a review of the offering memorandum. Black did not see a Sentinel EPA recycler prior to investing in Empire, did not speak to anyone at IMCO, and never did a personal investigation of the competition.

OPINION

In *Provizer v. Commissioner*, T.C. Memo. 1992-177, a test case involving the Clearwater transaction, this Court (1) found that each Sentinel EPE recycler had a fair market value not in excess of $50,000, (2) held that the Clearwater tarnsaction was a sham because it lacked economic substance and a business purpose, (3) upheld the section 6659 addition to tax for valuation overstatement since the underpayment of taxes was directly related to the overstatement of the value of the Sentinel EPE recyclers, and (4) held that losses and credits claimed with respect to Clearwater were attributable to tax-motivated tarnsactions within the meaning of section 6621(c). In reaching the conclusion that the Clearwater transaction lacked economic substance and a business purpose, this Court relied heavily upon the overvaluation of the Sentinel EPE recyclers.

Although petitioners have not agreed to be bound by the *Provizer* opinion, they have stipulated that their investment in the Sentinel EPE recyclers was similar to the investment described in *Provizer v. Commissioner*, *supra*. The underlying transaction in these cases (the Empire tarnsaction) is in all material respects identical to the transaction considered in the *Provizer* case. The Sentinel EPE recyclers considered in these cases are the same type of machines considered in the *Provizer* case.

Based on the entire records in these cases, including the extensive stipulations, testimony of respondent's experts, and petitioners' testimony, we hold that the Empire transaction was a sham and lacked economic substance. In reaching this conclusion, we rely heavily upon the overvaluation of the Sentinel EPE recyclers. Respondent is sustained on the question of the underlying deficiency. We note that petitioners have explicitly conceded this issue in stipulations of settled issues filed shortly before trial. The record plainly supports respondent's determination regardless of such concessions. For a detailed discussion of the facts and the applicable law in a substantially identical case, see *Provizer v. Commissioner, supra.*

Issue 1. Sec. 6653(a) Negligence

In the notice of deficiency in docket No. 36202-86, respondent determined that petitioners Black were liable for the negligence additions to tax under section 6653(a)(1) and (2) for 1981. Petitioners Black have the burden of proving that respondent's determination is erroneous. Rule 142(a); *Luman v. Commissioner*, 79 T.C. 846, 860-861 (1982). In an amendment to answer, respondent asserted that petitioners Bennett were liable for the negligence additions to tax under section 6653(a)(1) and (2) for 1981, and under section 6653(a) for 1978 and 1979. Because these additions to tax were raised for the first time in respondent's amendment to answer, respondent bears the burden of proof on this issue. Rule 142(a); *Vecchio v. Commissioner*, 103 T.C. 170, 196 (1994).

Section 6653(a) for 1978 and 1979 and section 6653(a)(1) for taxable year 1981 provide for an addition to tax equal to 5 percent of the underpayment if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations. Section 6653(a)(2) for taxable year 1981 provides for an addition to tax equal to 50 percent of the interest payable with respect to the portion of the underpayment attributable to negligence.

Negligence is defined as the failure to exercise the due care that a reasonable and ordinarily prudent person would employ under the circumstances. *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). The question is whether a particular taxpayer's actions in connection with the transactions were reasonable in light of his experience and the nature of the investment or business. See *Henry Schwartz Corp. v. Commissioner*, 60 T.C. 728, 740 (1973).

Petitioners each contend that they were reasonable in claiming deductions and investment credits with respect to their investment in Empire. To support this contention, petitioners each allege, in general terms, the following: (1) That claiming the deductions and credits with respect to Empire was reasonable in light of a so-called oil crisis in the United States in 1981, and (2) that in claiming the deductions and credits, petitioners reasonably relied upon Gallagher and the offering materials.

Petitioners argue, in general terms, that they were reasonable in claiming the deductions and credits related to Empire because of rising oil prices in the United States in 1981. Petitioners placed into the record several documents from the period 1979 to 1981, including speeches by William L. Wearly (Wearly), chairman of the board of Ingersoll-Rand; articles from Modern Platsics magazine; and an energy projections report from the U.S. Department of Energy (DOE). Wearly's speeches, given at colleges and universities, discussed business and national policy challenges. One of his concerns was U.S. dependency on foreign oil. The Modern Plastics articles and DOE report speculated on the price of oil, among other things. Petitioners failed to explain, however, the connection between these speculative materials and the Empire investment. We find petitioners' vague, general claims concerning the so-called oil crisis to be without merit.

Petitioners' reliance on *Krause v. Commissioner*, 99 T.C. 132 (1992) (citing *Todd v. Commissioner*, 89 T.C.

912 (1987), affd. 862 F.2d 540 (5th Cir., 1988), affd. sub nom. *Hildebrand v. Commissioner*, 28 F.3d 1024 (10th Cir. 1994), is misplaced. The facts in the *Krause* case are distinctly different from the facts of these cases. In the *Krause* case, the taxpayers invested in limited partnerships whose investment objectives concerned enhanced oil recovery (EOR) technology. The *Krause* opinion notes that during the late 1970's and early 1980's, the Federal Government adopted specific programs to aid research and development of EOR technology. *Id.* at 135-136. In holding that the taxpayers in the *Krause* case were not liable for the negligence additions to tax, this Court noted that one of the Government's expert witnesses acknowledged that "investors may have been significantly and reasonably influenced by the energy price hysteria that existed in the late 1970's and early 1980's to invest in EOR technology." *Id.* at 177. In the present cases, however, one of respondent's experts, Steven Grossman, noted that the price of plastics materials is not directly proportional to the price of oil, that less than 10 percent of crude oil is utilized for making plastics materials, and that studies have shown that "a 300% increase in crude oil prices results in only a 30 to 40% increase in the cost of plastics products." While EOR was, according to our *Krause* opinion, in the forefront of national policy and the media during the late 1970's and 1980's, there is no showing in these records that the so-called energy crisis would provide a reasonable basis for petitioners' investing in recycling of polyethylene, particularly in the machinery here in question.

Moreover, the taxpayers in the *Krause* opinion were experienced in or investigated the oil industry and EOR technology specifically. One of the taxpayers in the *Krause* case undertook significant investigation of the proposed investment including researching EOR technology. The other taxpayer was a geological and mining engineer whose work included research of oil recovery methods and who hired an independent geologic engineer to review the

offering materials. *Id.* at 166. In the present cases, Black testified that he has no formal background or education in plastics engineering or plastics processing, although he is knowledgeable about polyethylene "for the purposes of selling machinery", and nothing in the records indicates that Bennett had any experience or knowledge in plastics or plastics recycling. Moreover, although they had the personal ability to do so and the resources to have it done, petitioners did not independently investigate the Sentinel EPE recyclers. They did not hire an expert in plastics to evaluate the Empire transaction either. We consider petitioners' arguments with respect to the *Krause* case inapplicable.

Petitioners' reliance on *Rousseau v. United States*, 91-1 USTC par. 50252 (E.D. La. 1991), is similarly misplaced. In *Rousseau*, the property underlying the investment, ethanol producing equipment, was widely considered at that time to be a viable fuel alternative to oil and its potential for profit was apparent. In addition, the taxpayer therein conducted an independent investigation of the investment and researched the market for the sale of ethanol in the United States. In contrast, as we noted in distinguishing the *Krause* case, there is no showing in these records that the so-called energy crisis would provide a reasonable basis for petitioners' investing in the polyethylene recyclers here in question. See *supra* pp. 16-17. Petitioners did not indepedently investigate the Sentinel EPE recyclers or hire an expert in plastics to evaluate the Empire transaction. This inattention to the machinery involved in the transaction is particularly telling since petitioners each had experience in pricing and selling machinery and ready access to IMCO, an Ingersoll-Rand subsidiary involved in plastics and which Bennett believed used pellets like those produced by the Sentinel EPE recycler. The facts of petitioners' cases are distinctly different from the *Rousseau* case. Accordingly, we do not find petitioners' arguments with respect to the *Rousseau* case applicable.

In each of the cases before us, petitioners' investigation of the Empire transaction and the Sentinel EPE recyclers was limited to conversations with Gallagher and other Ingersoll-Rand executives and examination of the Empire offering materials. Nonetheless, petitioners argue that their reliance on Gallagher and the representations in the offering materials insulate them from the negligence additions to tax.

Under some circumstances a taxpayer may avoid liability for the additions to tax under section 6653(a)(1) and (2) if reasonable reliance on a competent professional adviser is shown. *Freytag v. Commissioner*, 89 T.C. 849, 888 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), affd. 501 U.S. 868 (1991). Reliance on professional advice, standing alone, is not an absolute defense to negligence, but rather a factor to be considered. *Id.* In order for reliance on professional advice to excuse a taxpayer from the negligence additions to tax, the reliance must be reasonable, in good faith, and based upon full disclosure. *Id.*; see *Weis v. Commissioner*, 94 T.C. 473, 487 (1990); *Ewing v. Commissioner*, 91 T.C. 396, 423-424 (1988), affd. without published opinion 940 F.2d 1534 (9th Cir. 1991); *Pritchett v. Commissioner*, 63 T.C. 149, 174-175 (1974).

Reliance on representations by insiders, promoters, or offering materials has been held an inadequate defense to negligence. *LaVerne v. Commissioner*, 94 T.C. 637, 652-653 (1990), affd. without published opinion 956 F.2d 274 (9th Cir. 1992), affd. without published opinion sub nom. *Cowles v. Commissioner*, 949 F.2d 401 (10th Cir. 1991); *Marine v. Commissioner*, 92 T.C. 958, 992-993 (1989), affd. without published opinion 921 F.2d 280 (9th Cir. 1991); *McCrary v. Commissioner*, 92 T.C. 827, 850 (1989); *Rybak v. Commissioner*, 91 T.C. 524, 565 (1988). We have rejected pleas of reliance when neither the taxpayer nor the advisers purportedly relied upon by the taxpayer knew anything about the nontax business aspects of the contemplated venture. *Beck v. Commis-*

sioner, 85 T.C. 557 (1985); *Flowers v. Commissioner*, 80 T.C. 914 (1983); *Steerman v. Commissioner*, T.C. Memo. 1993-447.

The record here shows that petitioners' "adviser" in this matter, Gallagher, possessed no special qualifications or professional skills in the recycling or plastics industries. Gallagher testified that Bankers Trust's due diligence involved only a review of the tax opinion letter. He explained that he relied upon the people at Ingersoll-Rand to make their own judgments of the value of the machines involved in the Empire transaction since many of them were engineers and many had their own resources to ascertain the value of machinery. Gallagher testified that the taxpayers he advised at Ingersoll-Rand concerning the Empire transaction "absolutely" understood that they were not to rely upon him as to the value of the machinery. While he purportedly read the offering memorandum, Gallagher could not recall at trial how the Empire transaction was structured, how Empire was to receive income, or how much its monthly lease payments were. Gallagher could not even recall the name of the purported end-user of the recycler in which he personally had invested.

Gallagher spoke with Taggart and Roberts, but the record does not indicate what representations they may have made to him or if he learned anything beyond the representations in the offering memorandum. Gallagher visited PI at the behest of Bennett. His observations were those of a layman, and he was careful to caution that he was not an engineer. As Bennett put it, Gallagher "could not assess the [Sentinel EPE recycler] machine in terms of its technical capability," but he could verify the existence of the machines.

In our view, petitioners' reliance on Gallagher was not reasonable. It was petitioners' reliance upon the purported values of the Sentinel EPE recyclers that generated the deductions and credits in these cases. Yet the purported value of the Sentinel EPE recyclers is the very thing that

petitioners and Gallagher did not verify. A taxpayer may rely upon his adviser's expertise (in these cases financial planning and tax advice), but it is not reasonable or prudent to rely upon an adviser regarding matters outside of his field of expertise or with respect to facts which he does not verify. See *Skeen v. Commissioner*, 864 F.2d 93 (9th Cir. 1989), affg. *Patin v. Commissioner*, 88 T.C. 1086 (1987); *Lax v. Commissioner*, T.C. Memo. 1994-329.

In fact, both Black and Bennett plainly were more capable of assessing the economic value of the recyclers than Gallagher because of their experience pricing machinery at Ingersoll-Rand. Petitioners also had ready access to the IMCO subsidiary of Ingersoll-Rand, which was involved in plastics and possibly used the same type of pellets produced by the Sentinel EPE recycler. Petitioners had a list of supposed end-users of the recycler and an open invitation from Gallagher to arrange for a tour to see the equipment in operation. Even though petitioners could have independently investigated the recyclers, they did nothing more than have Gallagher verify the existence of the recyclers. Petitioners expected no more from Gallagher, for as Bennett testified, he could not assess the machines from a technical standpoint. Petitioners are not insulated from the negligence additions to tax by claiming reliance on Gallagher.

Petitioners also contend that they read and reasonably relied upon the Empire offering memorandum and the reports of the evaluators annexed thereto. However, a careful consideration of the materials in the Empire offering memorandum, especially the discussions in the prospectus of high writeoffs and risk of audit, would have alerted a prudent and reasonable investor to the questionable nature of the promised deductions and credits. See *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988), affg. *Dister v. Commissioner*, T.C. Memo. 1987-217. The preface to the memorandum contained the following: NO OFFEREE SHOULD CONSIDER THE

CONTENTS OF THIS MEMORANDUM * * * AS * * * EXPERT ADVICE. * * * EACH OFFEREE SHOULD CONSULT HIS OWN PROFESSIONAL ADVISERS AS TO LEGAL, TAX, ACCOUNTING AND OTHER MATTERS RELATING TO ANY PURCHASE BY HIM OF UNITS. It also clearly stated that the Empire transaction involved significant tax risks and that in all likelihood the Internal Revenue Service would challenge the transaction. In a "business risks" section, it warned that there was no history for the partnership and no established market for the recyclers or the pellets.

At trial, Bennett could not recall having read those business risk warnings or the statements that there was no market for the recyclers or for the pellets of recycled plastic. Black could not recall having read that there was no market for the pellets or the recycler. Bennett testified that he was motivated by the report of Stanley M. Ulanoff (Ulanoff), a marketer, which was attached to the offering circular, even though Ulanoff had not done a marketing analysis or put a value on the machine. He also testified that in his experience, the price of machinery is generally predicated upon the performance aspects rather than the production cost. However, such an analysis was not done by Ulanoff. Black testified that he "relied on others" regarding the evaluation of the recycler, but that it was "in hindsight, not very brilliant on [his] part" to have done so. It is questionable from the records in these cases how closely petitioners read the offering memorandum and to what extent they relied on the representations therein. However, even if petitioners did thoroughly review the offering memorandum, such reading does not relieve them of negligence.

On its face, the Empire transaction should have raised serious questions in the minds of ordinarily prudent investors. According to the offering memorandum, the projected benefits for each $50,000 investor were investment tax credits in 1981 of $86,328 plus deductions in 1981

of $39,399. In the first year of the investment alone, petitioners each claimed an operating loss in the amount of $20,510 and investment tax and business energy credits related to Empire totaling $42,402, while petitioners each invested only $25,000 in Empire.[5] The direct reductions in petitioners' respective Federal income taxes, from just the tax credits, equaled 170 percent of their cash investment. Therefore, like the taxpayers in *Provizer v. Commissioner*, T.C. Memo. 1992-177, "except for a few weeks at the beginning, petitioners never had any money in the [Empire] deal." Indeed, Gallagher testified that he probably told petitioners that they would never be out of pocket on their Empire investment. A reasonably prudent person would not conclude without substantial investigation that the Government was providing significant tax benefits to taxpayers in these circumstances. *McCrary v. Commissioner*, 92 T.C. 827, 850 (1989).

The parties in these consolidated cases stipulated that the fair market value of a Sentinel EPE recycler in 1981 and 1982 was not in excess of $50,000. Notwithstanding this concession, petitioners contend that they were reasonable in claiming credits on their Federal income-tax returns based upon each recycler having a value of $1,162,666. In support of this position, petitioners submitted into evidence preliminary reports prepared for respondent by Ernest D. Carmagnola (Carmagnola), the president of Professional Plastic Associates. Carmagnola had been retained by the Internal Revenue Service in 1984 to evaluate the Sentinel EPE and EPS recyclers in light of what he described as "the fantastic values placed on the [recyclers] by the owners." Based on limited information available to him at that time, Carmagnola preliminarily estimated the value of the Sentinel EPE recycler to be $250,000. However, after additional informa-

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[5] Petitioners Bennett used $22,328 of the claimed credits on their 1981 return and carried back the unused portion of the credits to 1978 and 1979 in the respective amounts of $19,120 and $954.

tion became available to him, Carmagnola concluded in a signed affidavit, dated March 16, 1993, that the machines actually had a fair market value of not more than $50,000 each in the fall of 1981 and 1982.

We accord no weight to the Carmagnola reports submitted by petitioners. The projected valuations therein were based on inadequate information,[6] research, and investigation, and were subsequently rejected and discredited by their author. Respondent likewise rejected the reports and considered them unsatisfactory for any purpose; and there is no indication in the records that respondent used them as a basis for any determinations in the notices of deficiency. Even so, petitioners' counsel obtained copies of these reports and urge that they support the reasonableness of the values reported on their returns. Not surprisingly, petitioners did not call Carmagnola to testify in these cases,[7] but preferred instead to rely solely upon his preliminary, ill-founded valuation estimates. The Carmagnola reports were a part of the record considered by this Court and reviewed by the Sixth Circuit Court of Appeals in the *Provizer* case, where we held the taxayers negligent. Consistent therewith, we find in these cases, as we have found previously, that the reports prepared by Carmagnola are unreliable and of no consequence. Petitioners are not relieved of the negligence additions to tax based on the preliminary reports prepared by Carmagnola.

Petitioners' reliance on *Mollen v. United States*, 72 AFTR2d 93-6443, 93-2 USTC par. 50585 (D. Ariz.

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[6] In one preliminary report, Carmagnola states that he has "a serious concern of actual *profit-level*" of a Sentinel EPE recycler and that to determine whether the machines actually could be profitable, he required additional information from PI. Carmagnola also indicates that in preparing the report, he did not have information available concerning research and development costs of the machines and that he estimated those costs in his valuations of the machines.

[7] Carmagnola has not been called to testify in any of the Plastics Recycling cases before us.

1993) is misplaced. The taxpayer in *Mollen* was a medical doctor who specialized in diabetes and who, on behalf of the Arizona Medical Association, led a continuing medical education ("CME") accreditation program for local hospitals. The underlying tax matter involved the taxpayer's investment in Diabetics CME Group, Ltd., a limited partnership which invested in the production, marketing, and distribution of medical education video tapes. The taxpayer's personal expertise and insight in the underlying investment gave him reason to believe it would be economically profitable. Although the taxpayer was not experienced in business or tax matters, he did consult with an accountant and a tax lawyer regarding those matters. Moreover, as the District Court noted, the propriety of the taxpayer's disallowed deduction therein was "reasonably debatable."

The records in these cases, on the other hand, show no comparable evidence that either of petitioners or their "adviser," Gallagher, had formal education, expertise, or experience in plastics or plastics recycling, although Black explained that he had substantial knowledge of polyethylene for purposes of selling machinery. As a representative of Bankers Trust, Gallagher's due diligence responsibilities extended only to a review of the tax opinion letter. He took no responsibility for the valuation of the machinery in the Empire transaction. Petitioners had knowledge and experience in business and the pricing of machinery, and ready access to IMCO, a subsidiary of Ingersoll-Rand which manufactured plastic injection molding equipment, and which Bennett believed used the same type of pellets produced by the Sentinel EPE recycler. However, they did not utilize that knowledge and experience or consult anyone at IMCO with respect to the purported value of the Sentinel EPE recycler or its economic viability. The facts of these cases are distinctly different from those in the *Mollen* case. We find petitioners' arguments with respect to the *Mollen* case inapplicable.

Petitioners' arguments are not supported by *Anderson v. Commissioner*, 62 F.3d 1266 (10th Cir. 1995), affg. T.C. Memo. 1993-607, where the taxpayers were found liable for negligence additions to tax. In *Anderson*, the taxpayers claimed tax benefits based upon their acquisition of property listed at $124,500, but for which they actually paid $6,225 in a cash downpayment (5 percent of the purchase price) plus a 5-year financing arrangement. Had the acquisition been nothing more than a $6,225 passive investment, noted the Court of Appeals, it would have been reasonable for the taxpayers to rely on the advice of a good friend who had thoroughly investigated the investment.[8] However, because the transaction was structured and represented as a purchase in the amount of $124,500, the Court of Appeals held that something more was required.

In the cases before us, petitioners claimed tax benefits based on the assumption that they leased, through Empire, an interest in $8,138,662 worth of recycling machines. Based on their investments of $25,000 each, Black and Bennett each claimed a qualified investment in new investment credit property with a basis of $212,012, with resulting first-year tax credits of $42,402 and deductible losses of $20,510, a substantial transaction clearly requiring careful investigation under the *Anderson* case. Petitioners' adviser, Gallagher, reviewed the offering memorandum, had conversations with Taggart and Roberts, and visited the PI plant. Unlike the adviser in *Anderson*, he did not thoroughly investigate or educate himself in the industry being invested in. In fact, Gallagher made it clear at the trial that Bankers Trust's due diligence responsibilities regarding Empire were limited to a review

[8] The adviser had his accountant and attorney review and check out the structure of the investment; he spoke with the investment principal; he looked into the principal's background and checked out his references, banks, other business connections, and the Better Business Bureau; and he spoke with competitors to make sure the venture was viable.

of the tax opinion letter. In view of the $212,012 claimed basis for the interest of each petitioner in the machinery, from which the investment credits stemmed, a substantial amount and more than eight times greater than the cash invested, plainly something more was required. Accordingly, we find petitioners' reliance on the *Anderson* case inapplicable.

Under the circumstances of these cases, petitioners Bennett and Black failed to exercise due care in claiming the large deductions and tax credits with respect to Empire on their respective Federal income tax returns. We hold that petitioners did not reasonably rely upon Gallagher and the offering memorandum, or in good faith investigate the underlying viability, financial structure, and economics of the Empire transaction. In fact, the records indicate that petitioners were more influenced by the fact that their fellow executives at Ingersoll-Rand were investing in Sentinel EPE recycler partnerships than by anythink they learned from Gallagher or the offering memorandum. Black testified that he "was very impressed by the fact that some of our supposed financial geniuses at Ingersoll-Rand * * * all invested in this," while Bennett testified that he was "very much influenced" by the actions of his fellow executives and that the investment by people he respected "made a considerable impact" on him. However, in our view the record in these cases, including the testimony of Black and Bennett and their manner in presenting that testimony, establishes that they are men of education, experience, and talent in the business of manufacturing and selling machinery, that during the time in issue they were senior executives of a large machinery manufacturing company, that they were highly knowledgeable about appropriate pricing for a great variety of machinery, that they had the ability and resources to learn the value of the machinery involved in the Empire plastics recycling venture, in which they invested, and that they could have obtained such information without undue expense or effort.

Upon consideration of the entire records, we hold that petitioners are liable for the negligence additions to tax under the provisions of section 6653(a)(1) and (2) for 1981. Respondent is sustained on this issue.

Issue 2. Sec. 6659 Valuation Overstatement

In amendments to the answers, respondent asserted additions to tax with respect to petitioners in these cases under section 6659 for valuation overstatement. Because these additions were raised for the first time in amendments to the answers, respondent bears the burden of proof on these issues. Rule 142(a); *Vecchio v. Commissioner*, 103 T.C. 170, 196 (1994).

A graduated addition to tax is imposed when an individual has an underpayment of tax that equals or exceeds $1,000 and "is attributable to" a valuation overstatement. Sec. 6659(a), (d). A valuation overstatement exists if the fair market value (or adjusted basis) of property claimed on a return equals or exceeds 150 percent of the amount determined to be the correct amount. Sec. 6659(c). If the claimed valuation exceeds 250 percent of the correct value, the addition is equal to 30 percent of the underpayment. Sec. 6659(b).

Petitioners claimed tax benefits, including investment tax credits, based on purported values of $1,162,666 for each Sentinel EPE recycler. Petitioners each concede that during 1981 the fair market value of a Sentinel EPE recycler was not in excess of $50,000. Therefore, if disallowance of petitioners' claimed tax benefits is attributable to the valuation overstatement, petitioners are liable for the section 6659 additions to tax at the rate of 30 percent of the underpayments of tax attributable to the tax benefits claimed with respect to Empire.

Section 6659 does not apply to underpayments of tax that are not "attributable to" valuation overstatements. See *McCrary v. Commissioner*, 92 T.C. 827 (1989);

Todd v. Commissioner, 89 T.C. 912 (1987), affd. 862 F.2d 540 (5th Cir. 1988). To the extent taxpayers claim tax benefits that are disallowed on grounds separate and independent from alleged valuation overstatements, the resulting underpayments of tax are not regarded as attributable to valuation overstatements. *Krause v. Commissioner*, 99 T.C. 132, 179 (1992) (citing *Todd v. Commissioner, supra*), affd. sub nom. *Hildebrand v. Commissioner*, 28 F.3d 1024 (10th Cir. 1994). However, when valuation is an integral factor in disallowing deductions and credits, section 6659 is applicable. See *Illes v. Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992), affg. T.C. Memo. 1991-449; *Gilman v. Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991), affg. T.C. Memo. 1989-684 (section 6659 addition to tax applies if a finding of lack of economic substance is "due in part" to a valuation overstatement); *Masters v. Commissioner*, T.C. Memo. 1994-197; *Harness v. Commissioner*, T.C. Memo. 1991-321.

In the respective stipulations of settled issues, petitioners conceded that they "are not entitled to any deductions, losses, investment credits, business energy investment credits, or any other tax benefits claimed on their tax returns as a result of their participation in the Plastics Recycling Program." In *Todd v. Commissioner, supra*, and *McCrary v. Commissioner, supra*, we denied application of section 6659, even though the subject property was overvalued, because the related deductions and credits had been conceded or denied in their entirety on other grounds. In *Todd*, we found that an underpayment was not attributable to a valuation overstatement because property was not placed in service during the years in issue. In *McCrary*, we found the taxpayers were not liable for the section 6659 addition to tax when, prior to the trial of the case, the taxpayers conceded that they were not entitled to the investment tax credit because the agreement in question was a license and not a lease. In both

cases the underpayment was attributable to something other than a valuation overstatement.

This Court has held that concession of the investment tax credit in and of itself does not relieve taxpayers of liability for the section 6659 addition to tax. *Dybsand v. Commissioner*, T.C. Memo. 1994-56; *Chiechi v. Commissioner*, T.C. Memo. 1993-630. Instead, what is significant is the ground upon which the investment tax credit is disallowed or conceded. *Chiechi v. Commissioner, supra.* Even in situations in which there are arguably two grounds to support a deficiency and one supports a section 6659 addition to tax and the other does not, the taxpayer may still be liable for the addition to tax. *Gainer v. Commissioner*, 893 F.2d 225, 228 (9th Cir. 1990), affg. T.C. Memo. 1988-416; *Irom v. Commissioner*, 866 F.2d 545, 547 (2d Cir. 1989), vacating in part and remanding T.C. Memo. 1988-211; *Harness v. Commissioner, supra.*

No argument was made and no evidence was presented to the Court in the present cases to prove that disallowance and concession of the tax benefits related to anything other than a valuation overstatement. To the contrary, petitioners each stipulated substantially the same facts concerning the underlying transactions as we found in *Provizer v. Commissioner*, T.C. Memo. 1992-177. In the *Provizer* case, we held that the taxpayers were liable for the section 6659 additions to tax because the underpayment of taxes was directly related to the overvaluation of the Sentinel EPE recyclers. The overvaluation of the recyclers, exceeding 2325 percent, was an integral part of our findings in *Provizer* that the transaction was a sham and lacked economic substance. Similarly, the records in these cases plainly show that the overvaluation of the recyclers is integral to and is the core of our holding that the underlying transaction in these cases was a sham and lacked economic substance.

Consistent with our findings in *Provizer*, petitioners each stipulated that the Empire partnership had no net

equity value, that Empire's sole activity lacked any potential for profit, and that the Empire transaction therefore lacked economic substance. When a transaction lacks economic substance, section 6659 will apply because the correct basis is zero and any basis claimed in excess of that is a valuation overstatement. *Gilman v. Commissioner, supra; Rybak v. Commissioner*, 91 T.C. 524, 566-567 (1988); *Zirker v. Commissioner*, 87 T.C. 970, 978-979 (1986); *Donahue v. Commissioner*, T.C. Memo. 1991-181, affd. without published opinion 959 F.2d 234 (6th Cir. 1992), affd. sub nom. *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993).

We held in *Provizer v. Commissioner, supra*, that each Sentinel EPE recycler had a fair market value not in excess of $50,000. Our finding in the *Provizer* case that the Sentinel EPE recyclers had been overvalued was integral to and inseparable from our finding of a lack of economic substance. Petitioners conceded that the Empire transaction was similar to the Clearwater transaction described in *Provizer v. Commissioner, supra*, and that the Empire transaction lacked economic substance. Given those concessions, and the fact that the records here plainly show that the overvaluation of the recyclers was the reason for the disallowance of the tax benefits, and the fact that no argument was made and no evidence was presented to the Court to prove that disallowance and concession of the tax benefits related to anything other than a valuation overstatement, we conclude that the deficiencies caused by the disallowance of the claimed tax benefits were attributable to the overvaluation of the Sentinel EPE recyclers.

Finally, we consider petitioners' express argument as to waiver of the penalty. On brief, petitioners each contested imposition of the section 6659 addition to tax on the grounds that respondent erroneously failed to waive the addition to tax. Section 6659(e) authorizes respondent to waive all or part of the addition to tax for valuation overstatements if taxpayers establish that there was a rea-

sonable basis for the adjusted bases or valuations claimed on the returns and that such claims were made in good faith. Respondent's refusal to waive a section 6659 addition to tax is reviewable by this Court for abuse of discretion. *Krause v. Commissioner*, 99 T.C. at 179.

Petitioners urge that they relied on Gallagher and the offering materials in deciding on the valuation claimed on their tax return. Petitioners each contend that such reliance was reasonable, and, therefore, respondent should have waived the section 6659 addition to tax. Petitioners rely upon *Krause v. Commissioner, supra; Rousseau v. United States*, 91-1 USTC par. 50252 (E.D. La. 1991); and *Mauerman v. Commissioner*, 22 F.3d 1001 (10th Cir. 1994), revg. T.C. Memo. 1993-23, in support of their argument.

We have found that petitioners' purported reliance on Gallagher, and the offering materials was not reasonable. Gallagher was a representative of Bankers Trust. He was not an engineer and he never represented himself as being an expert in plastics or plastics recycling. In Gallagher's view, Bankers Trust's due diligence responsibility, and therefore Gallagher's own responsibility, was limited to reviewing the tax opinion letter included in the offering memorandum. The evaluators whose reports were attached to the offering memorandum each owned interests in partnerships that leased Sentinel EPE recyclers. The offering memorandum contained numerous caveats, including the folowing: NO OFFEREE SHOULD CONSIDER THE CONTENTS OF THIS MEMORANDUM * * * AS * * * EXPERT ADVICE. * * * EACH OFFEREE SHOULD CONSULT HIS OWN PROFESSIONAL ADVISERS. Petitioners were experienced in pricing machinery, yet they did not make the effort personally to see a Sentinel EPE recycler or independently investigate the machinery prior to investing in Empire.

Petitioners' reliance on *Krause v. Commissioner, supra, Rousseau v. United States, supra*, and *Mauerman v. Com-*

missioner, supra, in support of their contention that they acted reasonably, is misplaced. In the *Krause* and *Rousseau* cases, the section 6659 addition to tax was disallowed in light of the respective holdings that the taxpayers in each case had a reasonable basis for the valuations claimed on the tax returns or had reasonable cause for the understatement on the return and were not subject to negligence additions to tax. In contrast, we have held that petitioners herein did not act reasonably in claiming deductions and investment tax credits related to Empire, that the errors on petitioners' tax returns were caused by the excessive valuations of the underlying machinery in the Empire transaction, that petitioners lacked reasonable cause for such overvaluation, and that each petitioner is therefore liable for the negligence additions to tax under section 6653(a). See *supra* pp. 14-28. Accordingly, petitioners' reliance on the *Krause* and *Rousseau* cases is misplaced.

In *Mauerman v. Commissioner, supra*, the Tenth Circuit Court of Appeals held that the Commissioner had abused her discretion by failing to waive a section 6661 addition to tax. Like section 6659, a section 6661 addition to tax may be waived by the Commissioner if the taxpayer demonstrates that there was reasonable cause for his underpayment and that he acted in good faith. Sec. 6661(c). The taxpayer in *Mauerman* relied upon independent attorneys and accountants for advice as to whether payments were properly deductible or capitalized. The advice relied upon by the taxpayer in *Mauerman* was within the scope of his advisers' expertise, the interpretation of the tax laws as applied to undisputed facts. Particularly with respect to valuation, petitioners in these cases relied upon advice that was outside the scope of expertise and experience of their advisers. Consequently, we consider petitioners' reliance on the *Mauerman* case inapplicable.

We hold that petitioners did not have a reasonable basis for the adjusted bases or valuations claimed on their tax returns with respect to their investments in Empire. In these cases, respondent properly could find that petitioners' respective reliance on Gallagher and the offering materials was unreasonable. The records in these cases do not establish an abuse of discretion on the part of respondent but support respondent's position. We hold that respondent's refusal to waive the section 6659 addition to tax is not an abuse of discretion. Petitioners are liable for the respective section 6659 additions to tax at the rate of 30 percent of the underpayments of tax attributable to the disallowed tax benefits. Respondent is sustained on this issue.

To reflect the foregoing,

Decisions will be entered under Rule 155.

UNITED STATES TAX COURT

Docket No. 31758-85

KI-Plastics Recycling
Judge Wolfe

THOMAS E. BENNETT and JOAN A. BENNETT,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed January 22, 1996, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1978 in the amount of $19,120.00 and that there is an overpayment in income tax for the taxable year 1978 in the amount of $153.37, which amount was paid after the mailing of the notice of deficiency;

That there is a deficiency in income tax due from the petitioners for the taxable year 1979 in the amount of $954.00 and that there is an overpayment in income tax for the taxable year 1979 in the amount of $17.07, which amount was paid after the mailing of the notice of deficiency;

That there is a deficiency in income tax due from the petitioners for the taxable year 1981 in the amount of

$31,441.00 and that there is an overpayment in income tax for the taxable year 1981 in the amount of $22,160.00, which amount was paid after the mailing of the notice of deficiency;

That there are additions to tax due from the petitioners for the taxable years 1978 and 1979, under the provisions of I.R.C. § 6653(a), in the amounts of $956.00 and $48.00, respectively;

That there is an addition to tax due from the petitioners for the taxable year 1981, under the provisions of I.R.C. § 6653(a)(1), in the amount of $1,572.00;

That there is an addition to tax due from the petitioners for the taxable year 1981, under the provisions of I.R.C. § 6653(a)(2), in an amount equal to 50 percent of the statutory interest due on $31,441.00;

That there are additions to tax due from the petitioners for the taxable years 1978 and 1981, under the provisions fo I.R.C. § 6659, in the amounts of $5,736.00 and $6,587.00, respectively;

That there is no addition to tax due from the petitioners for the taxable year 1979, under the provisions of I.R.C. § 6659;

That $19,120.00 and $31,441.00, for the taxable years 1978 and 1981, respectively, are substantial underpayments attributable to tax-motivated transactions, for purposes of computing the interest payable with respect to such amount, pursuant to I.R.C. § 6621(c); and

That for the taxable year 1979, there is no substantial underpayment attributable to tax-motivated transactions, pursuant to I.R.C. § 6621(c).

(Signed) HOWARD A. DAWSON, JR.
Judge.

Entered: June 6, 1996

* * * *

UNITED STATES TAX COURT

Docket No. 36202-86

KI-Plastics Recycling
Judge Wolfe

THEODORE H. BLACK and MARILYN F. BLACK,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed January 22, 1996, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1981 in the amount of $52,875.00, of which $42,402.00 was paid on December 16, 1986 and $50.00 of which was paid on September 5, 1995, after the mailing of the notice of deficiency on June 27, 1986;

That there is an addition to tax due from the petitioners for the taxable year 1981, under the provisions of I.R.C. § 6653(a)(1), in the amount of $2,644.00;

That there is an addition to tax due from the petitioners for the taxable year 1981, under the provisions of I.R.C. § 6653(a)(2), in an amount equal to 50 percent of the statutory interest due on $52,875.00;

That there is an addition to tax due from the petitioners for the taxable year 1981, under the provisions of I.R.C. § 6659, in the amount of $12,721.00;

That for the taxable year 1981, $52,875.00 is a substantial underpayment attributable to tax-motivated transactions, for purposes of computing the interest payable with respect to such amount, pursuant to I.R.C. § 6621(c); and

That there is no addition to tax due from the petitioners for the taxable year 1981, under the provisions of I.R.C. § 6661

(Signed) HOWARD A. DAWSON, JR.
Judge

Entered: June 6, 1996

* * * *

It is stipulated that the Court may enter the foregoing decision.

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

STUART L. BROWN
Chief Counsel
Internal Revenue Service

/s/ Elliot I. Miller
ELLIOT I. MILLER
Counsel for Petitioners
Tax Court Bar No. ME0451
Kleban & Samor, P.C.
2425 Post Road
P.O. Box 763
Southport, CT 06490
Date: 2/26/96

By: /s/ David N. Brodsky
DAVID N. BRODSKY
Assistant District Counsel
Tax Court Bar No. BD0396
10 Causeway Street
Room 401
Boston, MA 02222-1061
Telephone: (617) 565-7895
Date: March 26, 1996

APPENDIX C

STATUTORY PROVISIONS INVOLVED

26 U.S.C. § 6653 (1982) [as amended by § 722(b)(1) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, Stat. 172]. FAILURE TO PAY TAX.

(a) *Negligence or intentional disregard of rules and regulations with respect to income, gift, or windfall profit taxes.*

(1) *In general.* If any part of any underpayment (as defined in subsection (c)(1) of any tax imposed by subtitle A, by chapter 12 of subtitle B, or by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(2) *Additional amount for portion attributable to negligence, etc.* There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601—

(A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paagraph (1), and

(B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

* * * *

26 U.S.C. § 6653 [prior to amendments made by Economic Recovery Tax Act of 1981, *supra*]. FAILURE TO PAY TAX.

(a) *Negligence or intentional disregard of rules and regulations with respect to income, gift, or windfall profit taxes.* If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A, by chapter 12 of subtitle B (relating to income taxes and gift taxes), by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

* * * *

FILED
JUN 22 1998
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 97-1717

In the Supreme Court of the United States

OCTOBER TERM, 1997

THOMAS E. BENNETT, JOAN A. BENNETT, THEODORE BLACK AND MARILYN BLACK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

SETH P. WAXMAN
Solicitor General
Counsel of Record

LORETTA C. ARGRETT
Assistant Attorney General

ANN B. DURNEY
JOAN I. OPPENHEIMER
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

19 pp

QUESTION PRESENTED

Whether, on the particular facts of this case, petitioners are liable for the negligence penalty imposed by Section 6653(a) of the Internal Revenue Code, 26 U.S.C. 6653(a) (1982).

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In the Supreme Court of the United States

OCTOBER TERM, 1997

No. 97-1717

THOMAS E. BENNETT, JOAN A. BENNETT, THEODORE BLACK AND MARILYN BLACK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The order of the court of appeals (Pet. App. 1a-2a) is unpublished, but the decision is noted at 131 F.3d 130 (Table). The opinion of the United States Tax Court (Pet. App. 3a-32a) is unofficially reported at 71 T.C.M. (CCH) 1737.

JURISDICTION

The order of the court of appeals was entered on December 26, 1997. On March 10, 1998, Justice Ginsburg extended the time for filing a petition for a writ of certiorari to April 27, 1998. The petition for a writ of certiorari was filed on April 21, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Section 6653(a) of the Internal Revenue Code imposes a penalty of five percent on any tax underpayment resulting from the "negligence" of the taxpayer. 26 U.S.C. 6653(a) (1982). The courts below both concluded that, on the particular facts of this case, petitioners were negligent in the underpayment of their tax obligations.

1. a. On their income tax returns for 1981, petitioners improperly claimed income tax deductions and credits from their participation in a tax shelter scheme involving a limited partnership known as Empire Associates. That partnership was formed to promote the plastics recycling tax shelter described in *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) 2531 (1992), aff'd mem., 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994).

This tax shelter involved a series of simultaneous sales, leases and licenses of machines designed to recycle plastic scrap (Pet. App. 8a). In 1981, Packaging Industries, Inc., manufactured and sold seven recyclers to ECI Corp. for $6,867,000, of which only $533,000 was paid in cash. ECI Corp. resold the recyclers to F & G Corp. for $8,138,667 ($1,162,666 each), of which only $618,000 was paid in cash. F & G Corp. then leased the recyclers to Empire Associates, which licensed them to FMEC Corp. That corporation then completed the circle by sublicensing the recyclers back to their original manufacturer, Packaging Industries, Inc. The monthly payments required among the entities involved in these transactions precisely offset each other—no cash changed hands (Pet. App. 7a). These circular transactions thus constituted a classic sham and tax shelter

scheme; they lacked any economic substance or business purpose *other than* the ostensible creation of tax deductions and credits. See *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) at 2547-2553.

The prospectus for the tax shelter scheme contained direct warnings of the tax risks presented by these sham transactions (J.A. 453):

> AN INVESTMENT IN THE PARTNERSHIP INVOLVES A HIGH DEGREE OF BUSINESS RISK AND SOME TAX RISKS AND SHOULD, THEREFORE, BE CONSIDERED ONLY BY PERSONS WHO * * * CAN AFFORD TO LOSE ALL OF THEIR CASH INVESTMENT AND SOME OF THEIR ANTICIPATED TAX BENEFITS.

The prospectus emphasized that the partnership had no operating history and that there was no established market for the recycling machines. As the trial court stated (Pet. App. 20a-21a) (emphasis added):

> [T]he Empire transaction should have raised serious questions in the minds of ordinarily prudent investors. According to the offering memorandum, the projected benefits for each $50,000 investor were investment tax credits in 1981 of $86,328 plus deductions in 1981 of $39,399. In the first year of the investment alone, petitioners each claimed an operating loss in the amount of $20,510 and investment tax and business energy credits related to Empire totaling $42,402, while petitioners each invested only $25,000 in Empire. *The direct reductions in petitioners' respective Federal income taxes, from just the tax credits, equaled 170 percent of their cash investment.*

The prospectus directly warned participants that, in view of the sizeable tax benefits claimed, the Internal Revenue Service would probably audit the income tax returns of the partnership and its partners (J.A. 474-475).

A tax opinion prepared by an attorney was attached to the prospectus (J.A. 565-629). The attorney acknowledged that he lacked a technical background and did not have a good understanding of engineering or of the development and design of the recycling machine (J.A. 787). His tax opinion was addressed to the general partner of Empire Associates, Richard Roberts. The opinion stated that it was for the "individual guidance" of Mr. Roberts and that investors should rely on their own advisors (J.A. 565).[1] Although the amount of any tax benefits to be realized from the transactions depended on the proper valuation of the recyclers, the attorney did not make or offer any personal valuation of that equipment. He merely cited "[t]he written evaluation of the Sentinel Recyclers furnished to the Partnership by one Evaluator [who] concludes that the purchase price to be paid by F & G therefor is fair and reasonable" (J.A. 585).[2] Although the attorney concluded that the tax

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[1] The prospectus similarly warned participants that "NO OFFEREE SHOULD CONSIDER THE CONTENTS OF THIS MEMORANDUM * * * AS * * * EXPERT ADVICE" and that "EACH OFFEREE SHOULD CONSULT HIS OWN PROFESSIONAL ADVISERS" (Pet. App. 19a-20a).

[2] The evaluator referenced in the attorney's opinion was Stanley M. Ulanoff, a Professor of Marketing at the School of Business of the City University of New York (J.A. 640). His "evaluation" consisted primarily of a discussion of the need for plastics recycling (J.A. 638-648). He did not do a marketing analysis and did not analyze the costs or anticipated revenues

benefits sought by the partnership would probably be achieved, his opinion emphasized that "the Service is not bound by and may challenges the conclusions reached in such report" (*ibid.*).

b. During the period of their investment in Empire Associates, petitioners Thomas Bennett and Theodore Black were vice-presidents of the Ingersoll-Rand Co. That company manufactures machinery such as construction equipment, pumps, air compressors, rock drills, pneumatic tools and bearings (Pet. App. 7a, 11a). In 1981, one of Ingersoll's subsidiaries manufactured plastic injection molding equipment that used the same type of pellets produced by the recycler used in the tax shelter scheme (*id.* at 11a, 21a).

Petitioners are engineers and both have attended the advanced management program at Harvard University (Pet. App. 10a). Between 1951 and 1968, petitioner Bennett was involved in marketing at Ingersoll-Rand and "continuously dealt with product pricing" (*ibid.*). By 1978, he had become vice president in charge of strategic planning for Ingersoll-Rand and was responsible for merger and acquisition analyses for the company (*ibid.*).

Petitioner Black ultimately became Ingersoll's chairman and chief executive officer. He previously had been an account manager, general manager, district manager and vice-president of the company (Pet.

---

from the recycler. Indeed, he did not refer in his "evaluation" to the ostensible purchase price ($1,162,666) of the recycler involved in this tax shelter scheme and, so far as can be determined from reviewing his report, was unaware of it. Another purported "evaluator" was a mathematics professor named Samuel Burstein. He concluded only that the equipment was operationally reliable and did not purport to determine the value of the equipment (J.A. 668).

App. 7a, 11a). Black, like Bennett, was an expert in product pricing (J.A. 307-310). He testified that he "kn[e]w a lot about what machinery costs" and "was very familiar with high priced special machinery" because "[t]hat's how [he] made [his] career in machinery" (J.A. 338).

Petitioners learned of the plastics recycling tax shelter from Edward Gallagher, an officer of Bankers Trust. (Pet. App. 8a). Gallagher, who had a bachelor of arts degree, toured a plant where the recyclers were in operation. He summarized his observations in a memorandum circulated to petitioners and other Ingersoll executives. His memorandum was prefaced with the statement that he did "not have an engineering background" (*id.* at 9a). He testified at trial that he expected petitioners to make their own judgments of the value of the recyclers because they were engineers and had better resources to ascertain the value of machinery (*id.* at 18a). He testified that the Ingersoll officers "absolutely" understood that they could not rely on him to determine the value of the recyclers (*ibid.*).

Petitioners, however, made no independent investigation or evaluation of the recyclers (Pet. App. 19a). Although they had ready access to the relevant information, they made no attempt to determine the *bona fide* value of the recyclers or their economic viability (*id.* at 23a).

Petitioners each invested $25,000 in the tax shelter scheme in 1981. Both then claimed an immediate operating loss of $20,510 and an investment tax credit

of $42,402 on their 1981 tax returns (Pet. App. 7a).[3] The investment tax credit was based on an alleged value of $1,162,666 per recycler (*id.* at 21a). The Commissioner disallowed the claimed tax benefits and asserted that petitioners were liable for penalties for negligence (26 U.S.C. 6653 (1982)) and for valuation overstatement (26 U.S.C. 6659 (1982)).

2. Petitioners sought review of the Commissioner's determinations in Tax Court. Prior to trial, petitioners stipulated that the fair market value of the recyclers did not exceed $50,000 in 1981 and that their limited partnership transactions lacked economic substance (Pet. App. 21a; J.A. 115, 145). They therefore conceded that they were not eligible for the claimed operating loss deductions and tax credits that they had claimed on their returns (Pet. App. 5a). They continued to assert, however, that they were not liable for the negligence penalty for claiming these improper deductions and credits.

The Tax Court sustained the negligence penalty and rejected petitioners' assertion that they had reasonably relied on expert advisors to determine the value of the recyclers (Pet. App. 13a-26a).[4] At trial, Bennett had admitted that he was better qualified than those on whom he allegedly relied to evaluate the plastics recycler (J.A. 236):

> THE COURT: * * * I'm puzzled that you relied upon a banker, a lawyer that was no

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[3] The Bennetts were unable to utilize the entire amount of the tax credits on their 1981 return. They sought to carry the asserted credits back to their 1978 and 1979 tax years (J.A. 89).

[4] The Tax Court also sustained the valuation overstatement penalty under 26 U.S.C. 6659. Petitioners no longer challenge the imposition of that penalty.

> engineer by his own admission in stipulated testimony, and your company's financial people with respect to a machine which you personally probably could have evaluated and analyzed better than these financial types.
>
> Why didn't you go look at it, or get somebody with a technical background to look at this machine for you?
>
> THE WITNESS: Well, Your Honor, I would say retrospectively that would have been a smarter thing to do.

Black similarly acknowledged that his asserted reliance on others to determine the value of the recyclers was, "in hindsight, not very brilliant" (Pet. App. 20a).

The court concluded that the express warnings in the prospectus concerning the tax risks, and the implausibly disproportionate tax benefits of the shelter scheme, would have alerted any prudent investor to the questionable nature of the project (Pet. App. 19a-21a). The court pointed out that the immediate tax credits claimed by petitioners were almost twice as great as the cash outlays required by the shelter scheme (*id.* at 21a). The court refused to credit the suggestion that petitioners relied heavily on Gallagher and concluded that any such reliance would have been unreasonable in light of the fact that petitioners had personal expertise in valuing machinery and had personal access to the information needed to determine the value of the recyclers. The court emphasized that (*id.* at 25a):

> the record in these cases, including the testimony of Black and Bennett and their manner in presenting that testimony, establishes that they are

men of education, experience, and talent in the business of manufacturing and selling machinery, that during the time in issue they were senior executives of a large machinery manufacturing company, that they were highly knowledgeable about appropriate pricing for a great variety of machinery, that they had the ability and resources to learn the value of the machinery involved in the Empire plastics recycling venture, in which they invested, and that they could have obtained such information without undue expense or effort.

3. The court of appeals affirmed the imposition of the negligence penalty "for substantially the reasons stated" in the Tax Court opinion (Pet. App. 2a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. For purposes of Section 6653, "negligence" is the lack of due care or failure to do what a reasonable and prudent person would do under similar circumstances. *Anderson* v. *Commissioner*, 62 F.3d 1266, 1270 (10th Cir. 1995). Whether a taxpayer is negligent is an inherently factual inquiry that depends, in part, on his education, intelligence, and sophistication. See, *e.g.*, *David* v. *Commissioner*, 43 F.3d 788, 789 (2d Cir. 1995); *H.G.A. Cinema Trust* v. *Commissioner*, 57 T.C.M. (CCH) 1066, 1072 (1989), aff'd, 950 F.2d 1357 (7th Cir. 1991), cert. denied, 505 U.S. 1205 (1992); *Heasley* v. *Commissioner*, 902 F.2d 380, 381 (5th Cir. 1990). The fact that a taxpayer has sought and obtained professional advice in connection with a transaction does not insulate him from the negligence

penalty. Good faith reliance on the advice of a qualified independent professional can, however, show that a taxpayer exercised due care. *United States* v. *Boyle*, 469 U.S. 241, 252 (1985); *Betson* v. *Commissioner*, 802 F.2d 365, 371 (9th Cir. 1986). The taxpayer's reliance must, of course, be reasonable in the circumstances. *Goldman* v. *Commissioner*, 39 F.3d 402, 408 (2d Cir. 1994); *Hanson* v. *Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983).

The courts below properly conducted the factual analysis required to determine whether petitioners acted with due and reasonable care. The finding of negligence in which both courts concurred is supported by the overwhelming weight of the evidence.[5] The prospectus, which was replete with warnings of business and tax risks, should have alerted petitioners to the questionable nature of the extraordinary tax benefits projected by the tax shelter scheme. Petitioners, who had engineering degrees and were vice-presidents of a machinery manufacturer, were experts in pricing machinery. They knew that their advisors lacked technical expertise and admitted that they could have evaluated the recycler better than their advisors (Pet. App. 18a, 20a). Further, they had "ready access to * * * an Ingersoll-Rand subsidiary involved in plastics and which Bennett believed used pellets like those produced by the * * * recycler" (*id.* at 16a). They could

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[5] The factual nature of the question presented is demonstrated by the fact that the Tax Court has concluded that some of the investors in this tax shelter scheme were *not* negligent. See, *e.g.*, *Zidanich* v. *Commissioner*, 70 T.C.M. (CCH) 367 (1995) (unsophisticated investors reasonably relied on the advice of others and were not liable for the negligence penalties).

have used this resource to obtain further information about the recycler.

The courts below also correctly rejected the contention that petitioners had reasonably relied on others in evaluating the shelter scheme. As the Tax Court concluded, petitioners were not primarily influenced by the advice of a professional advisor in determining the value of the recyclers, and any reliance on such advisors for that purpose would have been unreasonable in view of the lack of technical expertise on the part of the advisors to make such an appraisal (Pet. App. 14a, 18a).[6]

The factual determinations that petitioners acted without due care and without reasonable reliance on the advice of others are not clearly erroneous. There is no basis to disturb these findings "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)). See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985). Moreover, a challenge to such findings is not a suitable basis for obtaining review of the decision below in this Court. Sup. Ct. R. 10.

2. a. Petitioners plainly err in relying (Pet. 13) on the statement in *United States* v. *Boyle*, 469 U.S. at 251, that "[w]hen an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice." The issue with respect to which petitioners were negligent in this case does not involve any reliance on an opinion of an attorney with respect to a question "of tax law" (*ibid.*).

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[6] Moreover, the attorney's opinion expressly stated that it was for the guidance of the general partner only and that individual investors were not to rely on it (J.A. 565, 585).

The key to the tax benefits claimed by the tax shelter scheme involved in this case was the highly inflated price paid for the recycler. As the Tax Court emphasized, "[i]t was petitioners' reliance upon the purported values of the Sentinel EPE recyclers that generated the deductions and credits in these cases" (Pet. App. 18a). Neither the banker nor the attorney on whom petitioners claim to have relied purported to validate the price of the recyclers. As the Tax Court concluded, although an attorney may be capable of giving expert advice on a question of tax law, "it is not reasonable or prudent to rely upon an adviser regarding matters outside of his field of expertise or with respect to facts which he does not verify" (*id.* at 19a).

b. Petitioners are similarly incorrect in asserting that "the Tax Court's holding that a taxpayer is subject to the negligence penalty unless he obtains the advice of an expert who is knowledgeable in the technology" conflicts with decisions of the Fifth and Tenth Circuits (Pet. 10). The actual conclusion of the Tax Court is that the particular advisors on whom petitioners claimed to rely *were not* expert on the factual issue of valuation involved in this case—and that petitioners therefore did not reasonably rely on those advisors for that purpose (if, indeed, they relied on them at all for that purpose). See Pet. App. 19a. That conclusion is not even remotely similar to the broad proposition that petitioners attempt to make the basis for the alleged conflict.

That factual conclusion of the courts below does not conflict with the decisions of the Fifth and Tenth Circuits on which petiitoners rely. In *Anderson* v. *Commissioner*, 62 F.3d 1266 (10th Cir. 1995), the Tenth Circuit upheld the Tax Court's finding of

negligence on the ground "that a reasonable investor who was buying $124,500 worth of property for its long-term income producing potential would have done more to verify that the property actually existed and was actually producing or capable of producing income" than did taxpayers. *Id.* at 1272-1273. The court of appeals added that, if taxpayers had "conducted a reasonable investigation, * * * they would have learned that the GD & L container program was a sham and that they were not entitled to the deductions and credits they claimed for the investment." *Id.* at 1273. The court's further observation that "one does not have to be an expert in an industry before he can invest in the industry himself or recommend an investment to another" (*id.* at 1271) is manifestly not in conflict with any conclusion of the courts below in this case.

Similarly, *Chamberlain* v. *Commissioner*, 66 F.3d 729 (5th Cir. 1995), rev'g in part 67 T.C.M. (CCH) 2992 (1994), and *Durrett* v. *Commissioner*, 71 F.3d 515 (5th Cir. 1996), rev'g in part 67 T.C.M. (CCH) 2735 (1994), do not involve investors who were more knowledgeable than their advisors on the factual issues of importance in the negligence determination. In both of those cases, the taxpayers had engineering backgrounds but had no familiarity with forward contracts to purchase and sell mortgage-backed securities, which was the subject of the tax shelter in which they invested. 67 T.C.M. at 2742, 2994. In that circumstance, the Fifth Circuit found it reasonable for taxpayers to rely on advisors who were more knowledgeable of such transactions. In the present case, by contrast, petitioners acknowledged that they were *more* knowledgeable than their advisors on the critical factual issues and that they were aware of the

limitations of their advisor's expertise. See pages 7-8, *supra*.

Several courts of appeals have upheld the decisions that have imposed negligence penalties in connection with the claimed tax benefits from the plastics recycling tax shelter scheme.[7] See *Spears* v. *Commissioner*, 72 T.C.M. (CCH) 223 (1996), aff'd mem., 131 F.3d 131 (2d Cir. 1997) (Table); *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) 2531 (1992), aff'd mem., 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994); *Estate of Busch* v. *Commissioner*, 72 T.C.M. (CCH) 242 (1996), aff'd mem. *sub. nom. Snyder* v. *Commissioner*, 81 A.F.T.R.2d (RIA) 98-1279 (2d Cir. Mar. 12, 1998); *Morgan* v. *Commissioner*, 72 T.C.M. (CCH) 524 (1996), aff'd, No. 97-4599 (11th Cir. Mar. 9, 1998). There is thus no conflict among the circuits nor other reason to warrant review of the decision in this case.

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[7] In *Farrell* v. *Commissioner*, 136 F.3d 889 (2d Cir. 1998), the court of appeals held that the Tax Court had abused its discretion in permitting the Commissioner to amend his answer to assert additions to tax under 26 U.S.C. 6653 and 6659, when these additions were not asserted in the notice of deficiency and when the parties had stipulated that the only issues remaining in dispute were an adjustment of $20,050 and the disallowance of an investment tax credit.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

ANN B. DURNEY
JOAN I. OPPENHEIMER
Attorneys

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No. 97-1717

IN THE
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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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REPLY MEMORANDUM FOR THE PETITIONERS

STUART A. SMITH *
551 Madison Avenue
New York, New York 10022
(212) 759-8285
Attorney for Petitioners
* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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REPLY MEMORANDUM FOR THE PETITIONERS

1. In *United States v. Boyle*, 469 U.S. 241 (1985), this Court held, in unambiguous terms, that good faith reliance on a tax adviser establishes the reasonableness of the taxpayer's conduct so as to reject the Commissioner's assertion of the negligence penalty. In so holding, the Court necessarily assumed that the accountant or attorney upon whom the taxpayer relies was competent to render tax advice and that the adviser would not be burdened by a conflict of interest. However, the Court did not condition its holding upon a showing by the taxpayer that the adviser was expert in the particular technology underlying the taxpayer's investment.

The decision below squarely conflicts with the standard established by this Court in *Boyle*. In upholding the imposition of the negligence penalty in this case, the court of appeals ratified the conclusion of the Tax Court that

petitioners' reliance on the opinions of a reputable law firm and an officer of a major bank and its tax department was not reasonable because these advisers were not expert in the plastics recycling technology that underlay the particular investment. But this ruling cannot be reconciled with either *Boyle* or *Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995), and *Durrett v. Commissioner*, 71 F.3d 515 (5th Cir. 1996). In those two latter cases, the Fifth Circuit flatly held that under the teaching of *Boyle*, the taxpayers' reliance upon a lawyer for advice with respect to a complex straddle transaction involving forward securities contracts relieved them of the negligence penalty. While the government seeks to distinguish *Chamberlain* and *Durrett* on the purported ground that the taxpayers there relied "on advisors who were more knowledgeable of such transactions" (Br. in Opp., p. 13), that is assuredly not the case. Rather, the Tax Court in *Chamberlain* and *Durrett* premised its imposition of the negligence penalty on the ground that the advisers were not qualified because they "never understood how the program worked." (67 T.C.M. 2992, 2994; 67 T.C.M. 2735, 2742).[1] Hence, the government's attempts to distinguish *Chamberlain* and *Durrett* are unavailing. Indeed, if any doubt remains that the Fifth Circuit rejects the imposition of the negligence penalty against a taxpayer who relies upon a competent tax adviser, we call the Court's attention to the Fifth Circuit's recent decision in *Streber v. Commissioner*, No. 96-60443, decided April 15, 1998. There, the Fifth Circuit, in conformity with *Chamberlain* and *Durrett*, once again rejected the Tax Court's imposition of the negligence penalty against taxpayers who relied upon the advice of an attorney with respect to the reporting of a particular transaction on their tax return.[2] In these cir-

---

[1] In so holding, the Tax Court concluded in *Durret* and *Chamberlain* that the taxpayers "did not rely on competent independent parties . . . ." (67 T.C.M. 2742, 2994).

[2] For the convenience of the Court, we have reproduced the Fifth Circuit's opinion in *Streber v. Commissioner* in Appendix A, *infra*, pp. 1a-27a.

cumstances, "having done no less than reasonable prudence demands, the [taxpayers] should not be held negligent in their treatment of the joint venture income." Appendix A, *infra*, p. 7a. Accord: *Betson v. Commissioner*, 802 F.2d 365, 372 (9th Cir. 1986) (Kennedy, J.) (reliance upon *Boyle* for the proposition that "the taxpayer relied in good faith on the substantive advice of his accountant"). The decision below therefore conflicts with *Chamberlain* and *Durrett*.

2. Nor is the government on any sounder ground in asserting (Br. in Opp., pp. 13-14) that "Petitioners acknowledged that they were *more* knowledgeable than their advisors on the critical factual issues and that they were aware of the limitations of their advisor's expertise." (emphasis in original). The sole basis for the government's characterization is its citation of two excerpts of testimony by petitioners (Br. in Opp., pp. 7-8). But the excerpts of testimony cited by the government establish no such admissions by petitioners. When petitioner Bennett acknowledged that "retrospectively it would have been a smarter thing to [go to Hyannis] to examine the plastics recycling machinery" (J.A. 236; J.A. 238), he was simply stating that if such a trip would have served to establish his due diligence and absolve him of the negligence penalty, he regretted, in hindsight, not having done so. Plainly, Bennett was not "admitting" that he was more knowledgeable than the evaluators, the lawyer who rendered the opinion, the Bankers Trust officer, and the Bankers Trust organization, or that a trip to Hyannis by him would have made any difference. In sum, petitioners' hindsight expressions of regret regarding the purported wisdom of their making a visit to the factory that manufactured the machinery in question did not constitute admissions that they could have evaluated the machinery any more accurately than their advisers.[3]

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[3] Petitioner Black made the point even more forcefully. As Black stated, "I think I've tried to describe to you the degree that I studied the evaluation of the machines. I relied on others. *In hindsight*, not very brilliant on my part, but I don't know whether the

3. Furthermore, the government errs in asserting (Br. in Opp., p. 12) that the attorney upon whom petitioners relied did not validate the price of the recyclers. At the conclusion of his comprehensive written opinion, the attorney unambiguously stated that "it is our opinion that if questions are raised by the Internal Revenue Service with respect to [the numerous tax issues], they will be resolved in favor of the partnership." (J.A. 629). While the attorney earlier properly acknowledged in his opinion (J.A. 585) that the Internal Revenue Service was not bound by the written evaluation report appended to the offering memorandum (J.A. 638, 648), the attorney was required by the standards set forth in Treasury Circular 230, § 10.33(a)(1)(iv) to "examine the terms and conditions upon which the property was (or is to be purchased) to determine whether the stated purchase price reasonably may be considered to be its fair market value." See Appendix B, *infra*, pp. 28a-29a.[4] Hence, the attorney's positive opinion necessarily examined and agreed with the premises underlying the professional evaluation report that the price paid for the machinery and the rent paid by the partnership were "fair and reasonable" (J.A. 648).[5]

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outcome would have been much different." (J.A. 336) (emphasis supplied). To the same effect is Black's further statement that the analyses and advice he received from Taggart, Gallagher, and Bankers Trust were ultimately rejected eleven years later by the Tax Court in the *Provizer* case. As Black testified, "I felt I was getting enough input and *in hindsight* I was wrong." (J.A. 347) (emphasis supplied).

[4] For the convenience of the Court, we have reproduced in Appendix B, *infra*, pp. 28a-35a, the pertinent provisions of Treasury Circular 230, which prescribe the professional standards for the issuance of tax opinions such as the attorney's opinion in this case.

[5] There is likewise no merit to the government's argument (Br. in Opp. 10) that petitioners were negligent because the offering memorandum was "replete with warnings of business and tax risks . . . ." There is, however, nothing unusual about such disclosures in offering memoranda. Rather, they are a standard part

Nor is the government correct in asserting that petitioners were negligent because of "the extraordinary tax benefits" available to investors in the transaction. The fact that the amount of the tax benefits exceeded petitioners' cash investment was hardly a cause for concern. It is beyond question that petitioners were entitled to claim their aliquot share of the partnership's cost basis in the machinery. See Section 1012 of the Internal Revenue Code. However, the partnership's cost basis in the machinery was equal to the cash expended, plus the nonrecourse debt incurred in the acquisition of the machinery. This conclusion is a consequence of the bedrock federal income tax principles established by this Court's decisions in *Crane v. Commissioner*, 331 U.S. 1 (1947); and *Commissioner v. Tufts*, 461 U.S. 300 (1983).

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of such documents and attorneys' opinions in order that the offerors comply with the securities laws, which have been in place for more than sixty years. The inclusion of such warnings and risk factors in the offering memorandum was to inform prospective investors of both the positive and the negative aspects of the transaction in order that they could make an informed judgment as contemplated by the securities laws. See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

Moreover, the attorney's discussion of the tax risks in his opinion was fully in conformity with the professional standards set forth in Treasury Circular 230, *supra*. Section 10.33(a)(4) of Treasury Circular 230 provides that "Where possible, the practitioner must provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue presented by the offering memorandum which involves a *reasonable possibility of a challenge by the Internal Revenue Service*." (emphasis supplied.) See Appendix B, *infra*, p. 29a. Hence, in rendering such an opinion, a responsible practitioner such as Taggart was required to discuss the possibility of a challenge by the Internal Revenue Service. Accordingly, any reliance by the government and the decision below upon the discussion of tax risks in the offering memorandum and in the attorney's opinion betrays an entirely unrealistic view of the professional standards underlying the preparation of such offering materials and legal opinions.

4. In sum, the decision below departs from the standard established by this Court in *Boyle* and thereby casts doubt upon the heretofore well established proposition that a taxpayer cannot be subject to the negligence penalty for taking a reporting position on his tax return with respect to which he has sought advice from a competent tax professional who is not burdened by any conflict of interest. This Court should therefore grant review and reaffirm the teaching of *Boyle* that, "To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place." (469 U.S. at 251).[6]

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[6] The government denies that the decision below turns on the fact that the petitioners' advisers were not expert in the particular technology underlying their investment. Rather, the government argues (Br. in Opp., p. 10, n.5) that the factual nature of the question presented is illustrated by the fact that the Tax Court has concluded that "some of the investors" in the transaction at issue were not negligent. In support of this assertion, the government cites *Zidanich v. Commissioner*, 70 T.C.M. 367 (1995). The government's submission, however, leads precisely to the opposite conclusion. As the list of decisions set forth in Appendix C, *infra*, pp. 36a-38a demonstrates, the *Zidanich* ruling was the only case that the Tax Court Special Trial Judge ruled in favor of two taxpayers with respect to the negligence penalty. Apart from *Zidanich*, the Tax Court Special Trial Judge has thus far uniformly imposed the negligence penalty in 54 plastics recycling cases on the ground that the advisers were not expert in plastics recycling technology. Indeed, in one of these cases (*Merino*), the Tax Court Special Trial Judge found the taxpayer negligent even though he was a professor of engineering and a plastics and oil pricing expert who had personally inspected the machinery and its operation and closely questioned his colleagues at Celanese Corporation about the manufacturer's reputation, the machinery, and other similar machinery. See Appendix C, *infra*, p. 37a.

CONCLUSION

For the reasons stated above and in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted,

STUART A. SMITH *
551 Madison Avenue
New York, New York 10022
(212) 759-8285
Attorney for Petitioners

JULY 1998

* Counsel of Record

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

96-60443

TRACY P. STREBER, TERESA P. DELONY,
STEPHEN J. DAVIS,
Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeals from the United States Tax Court

April 15, 1998

Before KING, JONES, Circuit Judges, and KENDALL.[1]

JONES, Circuit Judge:

Two sisters were about 20 and 25 years old when they received over a million dollars each, and they hired a lawyer to advise them on potential tax liability. The Commissioner charged them with negligence and substan-

[1] District Judge for the Northern District of Texas, sitting by designation.

tial understatement penalties[2] for treating the money as a gift even though they followed one alternative course recommended by the tax lawyer and even though the Commissioner herself relied on their theory in asserting tax liability of the girls' father.[3] Under these circumstances, the Tax Court's imposition of the penalties was clearly erroneous. The Tax Court also erred in holding that Teresa's ex-husband procedurally defaulted his case. We REVERSE.

I. BACKGROUND

The underlying facts are simplified for present purposes. In 1979, Larry Parker, the girls' father, acquired an interest in 440 acres of underdeveloped land known as Northgate Forest Property. At least part of Parker's interest in this joint venture was held on behalf of his daughters. Teresa Deloney and Tracy Streber, who were then aged nineteen and fourteen. On March 4, 1981, two promissory notes in the amount of $2,000,000 each for sale of the land were endorsed, one to Teresa and the other one to Teresa as custodian for Tracy who was still a minor. Both notes were due and payable on March 4, 1985. Neither Teresa nor Tracy was involved in negotiating the terms of the agreement.

At some point, Parker and his then-wife, the sisters' mother, divorced.

When the notes were not paid on the due date, Parker, Teresa, Tracy, and other interested parties filed a suit against the makers of the notes. On April 23, 1985, the

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[2] I.R.C. § 6653(a), which has been amended following the commencement of this action, provided for additions to tax on account of negligence or intentional disregard of rules or regulations. I.R.C. § 6661(a), which has since been repealed, provided, during the years at issue, for an addition to tax in the case of an underpayment due to a substantial understatement.

[3] On appeal, the daughters do not, however, contest liability for the base amount of tax.

suit was settled, and Teresa and Tracy received eighty-five percent of the face value of the notes, i.e., $1,700,000 apiece.

Within a few weeks, Teresa and Tracy met with attorney Edwin Hunter to discuss the tax consequences of their income from the joint venture. Hunter provided Teresa and Tracy with two basic alternatives: (1) pay capital gains tax on the income they received; or (2) treat the income as a gift from Parker, who would then be liable for any taxes due on receipt of the money.

Teresa and Tracy chose the latter option. Neither Teresa, who filed a joint return with her then-husband Stephen Davis, nor Tracy reported receipt of the joint venture income on their 1985 tax returns. Parker did not report the receipt of the income either.

On October 22, 1991, the Commissioner issued statutory notices of deficiency to Tracy, Teresa, and Stephen for 1985, stating that Tracy and Teresa should have included the joint venture income they received in their 1985 income. All three filed petitions for redetermination of the deficiency in the Tax Court. Contemporaneously, the Commissioner, in order to avoid a "whipsaw" situation, also issued a statutory notice of deficiency against Parker and his wife for 1985. The notice of deficiency was based on the determination that the Parkers should have included in their 1985 income tax return the joint venture income that was paid to Teresa and Tracy. Parker and his wife filed a petition for redetermination of the deficiency in the Tax Court.

Upon a motion by the Commissioner, the Tax Court consolidated all three cases for trial. The Commissioner averred that either the Parkers or Teresa and Tracy were liable for the tax, but not both.

The Tax Court found no deficiency in Parker's 1985 income. Instead, the court found that Parker made a gift to his daughters in 1980, and, therefore, Tracy and Teresa

were liable for the taxes on the joint venture income received in 1985. The court also sustained the Commissioner's determination of additions to tax for negligence and substantial understatement against Tracy and Teresa. Finally, the Tax Court found that Davis had failed to prosecute his case and held him in default.

Teresa and Tracy filed a motion for reconsideration of the decisions concerning only the additions to tax. They argued that their actions were based on substantial authority and were reasonable and in good faith. Moreover, they maintained that their decision to treat the money as a gift from Parker was based on the advice they had received from counsel. Davis moved for reconsideration, claiming it was wrong for the court to have held him in default. The Tax Court vacated its decision in order to consider these motions.

Upon reconsideration, the Tax Court held that the sisters' assertion that there was substantial legal and factual justification for their failure to report the joint venture income was not sufficient to convince the court to change its determination that the addition to tax should apply. The Court did not believe that Tracy and Teresa "relied on an expert's advice." The Tax Court found:

> Movants met with an attorney, Edwin K. Hunter (Hunter), who, based on the facts as he knew them, explained to movants alternative tax reporting positions. However, we do not find that Hunter advised movants that they did not have to report the gains in question. The testimony on that point is ambiguous. Hunter, however, was one of the movant's attorneys and was present throughout the trial. Hunter no doubt could have resolved any ambiguity as to what he advised movants. Nevertheless, movants did not call Hunter as a witness. Our rules do not preclude Hunter from testifying. We infer from Hunter's failure to testify that his testimony would have been adverse to movants. Movants cannot claim that,

based on expert advice, they acted with due care, or as a reasonable and ordinarily prudent person would act, in the circumstances.

The Tax Court also rejected Davis's claim, holding that Davis had a full opportunity to participate at the trial and did not do so on his own account, although he participated in the proceedings as a witness.

Tracy and Teresa now appeal. They contend that the Tax Court erred in sustaining the Commissioner's assessment of the negligence and substantial understatement penalties. They argue that they reasonably relied on the advice they received from their attorney, and that reliance is not nullified under the factual circumstances of this case where the taxpayers choose one of the alternatives their advisor recommends.[4] Davis filed a separate appeal making the same claim and also arguing that the Tax Court abused its discretion in holding him in default.

II. ANALYSIS

A. NEGLIGENCE PENALTY

This court reviews the tax court's findings of negligence under the clearly erroneous rule. *See Sandvall v. Commissioner,* 898 F.2d 455, 459 (5th Cir. 1990). Clear error exists when this court is left with the definite and firm conviction that a mistake has been made. *See Chamberlain v. Commissioner,* 66 F.3d 729, 732 (5th Cir. 1995).

"The IRS may penalize taxpayers for an underpayment due to negligence or disregard of rules and regulations. Negligence includes any failure to reasonably attempt to comply with the tax code, including the lack of due care or the failure to do what a reasonable or ordinarily prudent person would do under the cirmumstances. 'Dis-

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[4] Edwin K. Hunter, appellants' counsel of record before the tax court, filed an amicus curiae brief.

regard' includes careless, reckless, or intentional conduct." *Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir. 1990) (citations omitted).

The relevant inquiry for the imposition of a negligence penalty is whether the taxpayer acted reasonably. *See Reser v. Commissioner*, 112 F.3d 1258, 1271 (5th Cir. 1995). "Taxpayers may not rely on someone with a conflict of interest or someone with no knowledge concerning the matter upon which the advice is given." *Chamberlain*, 66 F.3d at 732. "Good faith reliance on professional advice concerning tax laws is a defense." *Durrett v. Commissioner*, 71 F.3d 515, 518 (5th Cir. 1996).

In this case we find that the Tax Court clearly erred when it sustained the Commissioner's assessments of a negligence penalty, because appellants reasonably relied on the advice they received from their attorney, Edwin Hunter.

Due care does not require young, unsophisticated individuals to independently examine their tax liabilities after taking the reasonably prudent step of securing advice from a tax attorney.[5] At relatively tender ages, the appellants received large sums of money. Tracy Streber testified that she and her sister came to the conclusion that they had to seek advice from an attorney to make sure they did "the real thing." As she explained:

> It was just known that when you get money like that, some kind of tax had to be paid and we didn't know what it was, so we went to get counseled.
>
> . . . .

I knew that is why you had to go to a tax person. Given their level of understanding in these matters, the appellants took the appropriate steps to secure legal ad-

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[5] *Cf. Heasley v. Commissioner*, 902 F.2d 380, 383 (5th Cir. 1990) ("[D]ue care does not require moderate-income investors . . . to independently investigate their investments. They may rely on the expertise of their financial advisors and accountants . . . .").

vice from attorney Edwin Hunter to ensure that their tax returns for the upcoming year complied with the law. Not only Tracy Streber, but also Davis and Betty Berwick (Tracy and Teresa's mother, and Larry Paker's first wife) testified that the purpose of seeking legal advice was to understand the tax consequences of their income from the joint venture and to ensure that any position they took was on sound legal footing.

Hunter advised appellants that they could *either* treat the joint venture income as a capital gain or as a gift from Parker. Relying on Hunter's opinion, the appellants chose to treat the joint venture income as a gift. Due care does not require that the appellants challenge their attorney's opinion or independently investigate the propriety of his advice. *See Chamberlain,* 66 F.3d at 733. As the Supreme Court held:

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge an attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of the seeking the advice of a presumed expert in the first place. "Ordinary business care and prudence" do not demand such actions.

United States v. Boyle, 469 U.S. 241, 251, 105 S. Ct. 687, 692-93 (1985) (citation omitted). Having done no less than reasonable prudence demands, the appellants should not be held negligent in their treatment of the joint venture income.

The I.R.S. asserts that the Tax Court found that Hunter never advised them "that they did *not* have to report the gains in question." This conclusion, however, is contrary to the overwhelming weight of the evidence,

which supports the proposition Hunter did in fact tell the appellants that they should treat the joint venture income as a gift from Parker.

First, according to the witnesses, Hunter advised his clients to select the alternative that would result in more tax revenue for the government and would, therefore, be less likely to receive an I.R.S. challenge. Although the position the sisters ultimately adopted meant that they would not be personally liable for tax on their joint venture income when Hunter was rendering his advice, the appellants might have viewed a decision that would have resulted in less tax liability for their father than other positions would have required. The appellants were warned that Parker's own rather questionable practices might make them more susceptible to a government audit and possible penalties if they took anything less than a careful tax position in this case. Tracy Streber testified about the appellants' choice to treat the joint venture income as a gift: "We didn't want to defraud the government. We didn't want them to think we were in cahoots or whatever with my father, to defraud them." Because the gift tax rate was higher than the capital gains tax rate, Hunter stated that the I.R.S. might view the appellants' decision to treat the joint venture income as a capital gain as an attempt to conspire with Parker to limit his tax liability and the tax liability for all the family members.[6]

Second, the evidence shows that Hunter actively supported his clients' position to treat the joint venture income as a gift. In June 1986, for example, Parker's attorney wrote to Hunter encouraging him to reconsider Hunter's filing of the appellants' amended tax returns, which "reflect[ed] their receipt of certain income as a

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[6] Davis testified that Hunter explained that if they were to choose to treat the joint venture income as a capital gain, it was very likely that the I.R.S. would maintain that they "still have a liability as far as owing tax on the money."

gift from their father."[7] A month earlier, Hunter participated in his clients' efforts to notify the IRS of the possible deficiencies in Parker's 1985 tax return.[8] Given the substantial risks associated with voluntarily reporting to the IRS in this case, it is hard to understand how the Tax Court could have concluded that Hunter would have advised the appellants to take any position other than the one they adopted in this matter. Although the appellants understood that by informing the agency they might receive a financial reward from the government if the information proved useful, they must also have understood that this action would highlight their own tax returns for scrutiny.[9] The decision to inform on Parker to the I.R.S. not only placed the appellants at personal risk of a government audit, but it also placed Hunter's professional judgment and reputation under review. In the face of this risk, Hunter actively promoted his clients' tax position. It is impossible to reconcile Hunter's later actions with the Tax Court finding that this initial tax advice to the sisters was "ambiguous" or that he did not actually recommend treating the joint venture income as a gift.[10]

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[7] Letter from David S. Gamble, Attorney to Larry Parker, to Edwin K. Hunter 1 (June 25, 1986).

[8] *See* Memorandum of Interview, Internal Revenue Service (May 9, 1986) (noting the presence of Edward K. Hunter, Attorney for Informants, Teresa Davis and Stephen Davis).

[9] The Evaluation Report on Claim for Reward makes clear that the information provided to the IRS had substantial value, because otherwise Parker's 1985 tax return would not have been audited.

[10] The dissent does not even mention the correspondence between Hunter and Parkers' attorney, which has to be premised on Hunter's advice that the income the girls received was a gift. The dissent, like the Tax Court, casts no doubt on the veracity of Berwick's and Davis's testimony about Hunter's advice. Finally, the dissent unnecessarily flays Hunter over a subsequent legal malpractice action the girls have pending against him. The lawsuit is irrelevant to the question of their lack of negligence and due diligence, at least in a case such as this, where the advice he gave—that there was a gift—

The IRS also contends that Tracy and Teresa did not in fact rely on Hunters advice, propounded in alternatives, because they made the "ultimate decision" not to report the income from the joint venture on their tax returns. IRS does not dispute that the legal advisor here offered several possibilities and discussed the tax ramifications of each.[11] IRS contends, however, that because the Tax Court found he did not affirmatively recommend a preferred course of action, which the taxpayers followed, the reliance on counsel defense is unavailable. We need not reach this conclusion because, overruling the Tax Court's erroneous findings, we find that Hunter did in fact affirmatively advise and vigorously assist taxpayers' chosen course of action. But even if the Tax Court's findings here are accurate, unless circumstances show that a tax advisor discussed *and discounted* alternative tax strategies, the taxpayers should ordinarily not be held negligent for following any of the bona fide alternatives developed by an advisor acquainted with the relevant facts. To find otherwise adds a new requirement to the reliance on counsel defense: not only must the taxpayer show that his advisor discussed how to treat a tax-related transaction, he must also show that the advisor ranked any alternatives hierarchically, and he (the taxpayer) adopted whichever alternative was at the top of the list. Otherwise, the advisor's recommendation in a situation where bona fide alternative tax strategies exist will be found "ambiguous" and cannot furnish the basis for a taxpayer's reasonable reliance. If this proffered method of analysis is not simply

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was sound enough to be the basis of one of IRS's alternative positions.

[11] The dissent goes even further than the Tax Court did in implying that Tracy and Teresa decided on their own not to report the income from the notes. First, the dissent does not concede, as IRS does, that Hunter advised the girls of alternative tax treatments of the income. Second, the dissent accuses the girls of not furnishing Hunter with appropriate documentation, but neither IRS nor the Tax Court mentioned this sort of problem, which is not inferable from any of the Tax Court's findings.

a semantical quibble designed to determine the outcome of this case, it drives a mischievous wedge between advisors and taxpayers. Advisors will be deterred from recommending alternative tax strategies, and clients will be discouraged from seeking any but the most tax-advantageous advice.

The I.R.S. finally emphasizes that the Tax Court ruled against the appellants because the court did not find Tracy Streber and Teresa Deloney to be credible. The Tax Court gave their testimony and answers "little weight." Moreover, in its opinion on reconsideraton, the Tax Court noted that Hunter could have testified on behalf of the appellants to clear up any ambiguity that might have existed over whether he, in fact, advised them to treat the joint venture income as a gift from Parker. Because the appellants chose not to call him as a witness, the court inferred his testimony would have been adverse to their position. This reasoning is unpersuasive.

In general, a court may draw a negative inference from a party's failure to produce a witness "whose testimony would elucidate the transaction." *Graves v. United States*, 150 U.S. 118, 121, 14 S. Ct. 40, 41 (1893). The strength of the inference "is rooted in notions of common sense[,] . . . will vary with the facts of each case," *United States v. Tucker*, 552 F.2d 202, 210 (7th Cir. 1977), and may be drawn only where a witness has information "peculiarly within his knowledge," *McKay v. Commissioner*, 886 F.2d 1237, 1238 (9th Cir. 1989) (citing *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946)). Thus, a party need not call a witness whose testimony would be cumulative "without any apprehension" that a court will draw a negative inference." 2 John Henry Wigmore, *Evidence* § 287, at 202-03 (Chadbourne rev. 1979).[12]

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[12] "In general, put somewhat more strongly, there is a general limitation . . . that the inference cannot fairly be drawn except from the nonproduction of witnesses whose testimony would be superior in respect to the fact to be proved." 2 Wigmore § 287, at

In this case, the tax court examined the evidence of four witnesses who were privy to Hunter's conversation with his clients. These witnesses, Teresa, Tracy, Davis, and Berwick, all testified that Hunter advised his clients that they could either pay capital gains tax on the income they received or treat the income as a gift from Parker. Even assuming that Teresa and Tracy were not credible, the Tax Court never referred to the testimony of Davis and Berwick, who each confirmed that Hunter did advise his clients to treat the joint venture income as a gift from Parker. Davis said that Hunter "felt from . . . hearing the case and the documents—he felt that it was a gift." When Berwick was asked why the appellants chose to treat the income as a gift, she answered: "Because Mr. Hunter told them that in his opinion, that was the correct one." Contrary to this testimony, which the Tax Court neither questioned nor commented upon, the court still held that it could not find that "Hunter advised [appellants] that they did *not* have to report the gains in question." Once again, even assuming Tracy Streber and Teresa Deloney were not credible, at least two other witnesses independently supported the position that Hunter had advised his clients to treat the joint venture income as a gift from Parker. This testimony was uncontradicted. Moreover, because Hunter's testimony would have been cumulative, and maybe counter-productive—focusing attention away from the primary issue of whether his clients were liable in the first place—and because the subject of Hunter's advice was not peculiarly within his knowledge, *see McKay*, 886 F.2d at 1238, the tax court erred when it drew an inference adverse to the appellants. To hold otherwise would in

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203. Two witnesses—Berwick and Davis—whose credibility went unchallenged by the IRS were present during the meeting in which Hunter rendered his advice. Under these circumstances, Hunter's hypothetical testimony could not fairly be characterized as superior to that of these other witnesses. Their testimony of what they heard Hunter say is not a priori inferior to Hunter's possible testimony of what he remembers advising to his clients.

essence require the attorney to testify in all cases involving an advice of counsel defense.

After reviewing the record, "we are left with the definite and firm conviction that a mistake has been made." *Chamberlain*, 66 F.3d at 732. The appellants did rely on their attorney's advice when they elected to treat the joint venture income as a gift from Parker. Furthermore, given the appellants' relative youth and inexperience in business matters, they acted with all the care a reasonably prudent person would exercise under similar circumstances. *See Reser*, 112 F.3d at 1271. Our laws demand nothing more. Thus, we hold that the Tax Court clearly erred when it sustained the imposition of negligence penalties against the appellants.

B. SUBSTANTIAL UNDERSTATEMENT PENALTY

The second issue before this court is whether the Tax Court abused its discretion when it held appellants liable for the addition to tax for substantail understatement, pursuant to I.R.C. § 6661(a). *See Heasley v. Commissioner*, 902 F.2d 380, 385 (5th Cir. 1990). Section 6661 provides for an addition to tax equal to twenty-five percent of the amount of any underpayment attributed to a substantial understatement of tax. If a taxpayer is able to show that there was a reasonable cause for the understatement and good faith, which may stem from reasonable reliance on the advice of professional, the I.R.S. may waive the understatement penalty. *See Heasley*, 902 F.2d 384-85; *see also Reser v. Commissioner*, 112 F.3d 1258, 1271-72 (5th Cir. 1997).

First, as has been noted, the appellants reasonably relied on the advice they received from their attorney. IRS acknowledges that "the extent of the taxpayer's effort to assess her proper tax liability under the law is the most important factor" in determining reasonable cause and good faith. *Heasley*, 905 F.2d at 385. Because of appel-

lants' youth, inexperience in business, reliance on counsel, and proof of "good faith" in their position by reporting the transaction to the Service as their father's potential liability, the conclusions this court reached in *Heasley* are controlling:

> Applying the I.R.S.'s own regulatory standards, we find that the I.R.S. abused its discretion by failing to waive the penalty in this case. We are at a loss to determine just what the I.R.S. would find to be a reasonable cause given the Heasleys' experience, knowledge, and education. First, the Heasley's attemped to assess their proper tax liability by taking their taxes to a C.P.A., something they never did before. The accountant found no problem with the plan. While Danner suggested that the Heasley's use Smith, nothing else in the record connects the two. Therefore, considering this "most important factor," the Heasleys showed reasonable cause and good faith. Second, the Heasleys read the portions of the prospectus and other O.E.C. materials and relied on Danner to explain the rest. If neither Danner nor their C.P.A found anything wrong with the investment, how could the Heasleys? Certainly, their failure to outguess their financial advisor and accountant is not negligence. Finally, the Heasleys believed that they legitimately claimed the deduction and investment tax credit. Given the Heasleys' inexperience and limited knowledge about investing, and their level of education, their misunderstanding is reasonable, the I.R.S. abused its discretion by failing to waive the penalty and the tax court erred by upholding the I.R.S.'s decision.

Second, I.R.S. too narrowly interprets the meaning of the substantial authority defense on which appellants rely to defeat this penalty.[13] This case turned on one factual

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[13] I.R.C. § 6661(b)(2)(B)(i) provided that any "substantial" understatement of tax "shall be" reduced "by that portion of the

issue: when Parker made the gift to his daughters. If the gift was made before 1985, Tracy and Teresa are liable for the income they received in 1985; if it was effectively made in 1985, Parker is liable. The subsidiary facts relating to this transaction were complex, largely undisputed, and not materially affected by the Tax Court's assessment of the sisters' lack of credibility. In a recent decision, the Eleventh Circuit explained that where the substantial authority issue runs on evidence going both ways, "there is substantial authority from a factual standpoint for the taxpayer's position. Only if there was a record upon which the Government could obtain a reversal under the clearly erroneous standard could it be argued that from an evidentiary standpoint, there was not substantial authority. . . ." *Osteen v. Commissioner*, 62 F.3d 356, 359 (11th Cir. 1995). Apart from trying to confine *Osteen* to its facts, an untenable position, I.R.S. does not demonstrate how its principle is inapt here. The government makes no effort to assert that the only rational tax treatment of the transaction was as a gift made before 1985.[14]

For these reasons, the I.R.S. abused its discretion in failing to waive the penalty and the Tax Court erred in upholding the I.R.S.'s decision. *See Heasley*, 902 F.2d at 385. It is clear upon review of the record that the appellants had substantial factual authority for the tax position they asserted and reasonably relied on the advice of their attorney.

C. FAILURE TO PROSECUTE

Because we have held that the sisters are not liable for negligence and substantial understatement penalties, we

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understatement which is attributable to []the tax treatment of any item . . . if there is or was substantial authority for such treatment . . . ."

[14] The dissent ignores Osteen and makes a legal argument that neither IRS nor the Tax Court did, namely, that "substantial authority" means only legal, not factual authority.

need not reach the merits of the dispute over Davis's possible failure to prosecute. Davis's derivative liability for his ex-wife's income vitiates a default judgment. The Tax Court decision holding the appellant in default for failure to prosecute his case is reversed.

CONCLUSION

These appellants are not liable for negligence and substantial understatement penalties from their decision to treat the joint venture income as a gift. The decision of the Tax Court is REVERSED.

KING, Circuit Judge, dissenting:

In reversing the judgment of the tax court, the majority errs on two levels. First, under the guise of a review only for clear error, the majority rejects the tax court's determination that the appellants were liable for an addition to tax based upon their negligence pursuant to former § 6653 of the Internal Revenue Code. In so doing, the majority exceeds its authority as an appellate court by usurping the fact-finding function properly relegated to the tax court. Second, the majority concludes that the tax court erred in holding the appellants liable for an addition to tax based upon a substantial understatement of their tax liability because substantial authority within the meaning of former § 6661 of the Internal Revenue Code existed for the tax position taken by the appellants. In order to justify this conclusion, the majority adopts a construction of the substantial authority standard that fails to comport with the treasury regulations interpreting § 6661 and that strips the statute of much of its force as a deterrent of taxpayer misconduct. I respectfully dissent.

I. Addition to Tax for Negligence

The majority improperly holds that the tax court clearly erred in finding that the appellants acted negligently in declining to report the joint venture income as a capital

gain and that the appellants were therefore liable for negligence penalties pursuant to former § 6653(a) of the Internal Revenue Code. *See* 26 U.S.C.A. § 6653(a) (West 1989) (amended in 1989). Because the majority makes no mention of the burden of proof applicable to the parties' dispute over the negligence penalty, it is worth noting here that the Commissioner's determination of negligence is presumed correct and that the taxpayer therefore bears the burden of proving the absence of negligence. *See Westbrook v. Commissioner,* 68 F.3d 868, 880 (5th Cir. 1995); *Sandvall v. Commissioner,* 898 F.2d 455, 459 (5th Cir. 1990).

The majority concludes that the tax court erred in declining to accept the appellants' contention that their failure to report the income from the joint venture on their 1985 tax returns did not constitute negligence because they made the decision based on the advice of counsel. In reaching this conclusion, the majority pays lip service to the fact that, as an appellate court, our review of the tax court's finding of negligence is limited to a review for clear error. *See Streber v. Commissioner,* —— F.3d at —— (5th Cir. 1998), Majority op. at 6 (citing *Sandvall,* 898 F.2d at 459). It then proceeds to conduct a thinly veiled de novo review of the facts, reversing the tax court's judgment regarding the negligence penalty merely because it reaches a different factual conclusion than that reached by the tax court. The majority's conclusion that "the overwhelming weight of the evidence . . . supports the proposition [Edwin] Hunter did in fact tell the appellants that they should treat the joint venture income as a gift from Parker," *Streber,* —— F.3d at ——, Majority op. at 9, simply cannot withstand scrutiny.

First, the majority points to the testimony of Tracy Streber, Teresa Deloney (by affidavit and deposition), Betty Berwick, and Steve Davis as establishing that Hunter told the appellants that they should treat the joint venure income as a gift. Credibility assessments regarding this

testimony were exclusively within the province of the tax court, as it was the trier of fact. *See Durrett v. Commissioner*, 71 F.3d 515, 517 (5th Cir. 1996). The tax court explicitly concluded that it "did not find [Tracy and Teresa] to be credible witnesses" and therefore accorded their testimony "little weight." While it is not our place as an appellate court to strictly scrutinize the tax court's credibility determinations, it is worth noting that the court had every reason to make the credibility assessments that it did in this case.

Tracy's testimony at trial was exceptionally vague and riddled with lapses of memory. For example, when asked by the court what advice Hunter had given Tracy and her sister, Tracy replied as follows: "I don't—well, there was this chalk talk thing, and there was—and ultimately it was, well it was a gift. And we—you know, that is—so your dad owes the tax." When answering a number of related questions posed by the court regarding the sisters' meeting with Hunter, Tracy responded that she could not remember or did not know. The tax court could properly decline to credit Tracy's testimony. *See id.; see also MacGuire v. Commissioner*, 450 F.2d 1239, 1244 (5th Cir. 1971) (" 'The Tax Court not only may, but should, base its findings on the testimony it believes to be true, rejecting after due consideration that which it believes is false.' " (quoting *Boyett v. Commissioner*, 204 F.2d 205, 208 (5th Cir. 1953))).

The tax court concluded that Teresa, whose affidavit and deposition were entered into evidence, had "failed to tell the truth" in "various important respects." The court specifically concluded that Teresa had previously misrepresented her involvement in reporting her father's alleged understatement of his tax liability to the IRS. In response to interrogatories sent to her in the discovery phase of the trial, Teresa made the following statment:

> I never gave advice to the Internal Revenue Service about shortcomings in the income tax returns filed by Larry and Martha [Parker] for 1985, nor do I have personal knowledge that any relative or counsel did so.

When later asked in deposition whether she provided the IRS with any communication regarding her father's tax liability, she stated that she did not remember making such a communication. When asked if she had heard of anyone else making such a communication, she stated that she "ha[d] heard" during the pretrial proceedings "[t]hat it was done." When asked by whom, she responded "by myself and my husband through our attorney." When asked in a later deposition session what this earlier statement meant, Teresa responded, "It means that all I have heard in these proceedings is that—that Steve and I were supposedly the informants, but I have no knowledge of who informed, when it was done. I did not do it. He did not do it." A reward application bearing Teresa's signature and containing information regarding her father's tax liability was filed with the IRS and entered into evidence. Additionally, an IRS memorandum reciting that Teresa was in attendance at a meeting with an IRS special agent in 1986 at which she provided information relating to her father's 1985 tax return was also entered into evidence. Based on its conclusion that Teresa had testified falsely about her involvement in informing on her father to the IRS, the tax court had every right to infer that Teresa had also testified falsely about the advice that she received from Hunter and her reliance on it. *See Tousaint v. Commissioner*, 743 F.2d 309, 312 (5th Cir. 1984) (concluding that the tax court could properly infer that the taxpayer had testified falsely about a particular matter based on the taxpayer's false testimony regarding a related matter).

The majority also notes that two other witnesses—Berwick and Davis—indicated that Hunter felt that Tracy

and Teresa could legally treat the joint venture income as a gift from their father and decline to report it as a capital gain. As noted earlier, the tax court had the exclusive authority to make credibility assessments regarding this testimony. More importantly, however, none of the witnesses established that Tracy and Teresa provided Hunter with all of the information relevant to an informed determination of the appropriate tax treatment of the joint venture income.

In order to take advantage of the defense to negligence penalties provided by good-faith reliance on the advice of counsel, a taxpayer must prove that the advice of counsel allegedly relied upon was "based on knowledge of all the facts" relevant to the advice given. *See Leonhart v. Commissioner,* 414 F.2d 749, 750 (4th Cir. 1969), *cited with approval in Heasley v. Commissioner,* 902 F.2d 380, 383-84 n.8 (5th Cir. 1990). The taxpayers did not meet this burden here.

Tracy testified at trial that she did not provide Hunter with any documents relating to the joint venture and that she could not remember whether anyone else provided Hunter with any such documents. Teresa's affidavit states that she and Davis "provided Mr. Hunter numerous documents [they] believed relevant to this situation and other legal matters [they] were discussing with him," but does not specify the exact nature of those documents. Davis testified that Teresa provided Hunter with some documents, but was vague as to their contents. When asked what kind of documents Teresa provided to Hunter, Davis stated, "She had, you know, documents how the deal—you know, wasn't a lot of documents, but she did have some as far as the deal—land deal. . . ." As to what Hunter was told at the meeting with the sisters, Tracy testified that she "[could] only speculate" about what she had told Hunter and that she "[could not] speak for [her] sister." Such testimony fails to establish that Hunter knew all of the facts relevant to a determination of whether the

joint venture income constituted a gift and therefore fails to establish that Tracy and Teresa did not act negligently.

The majority next concludes that, in light of the fact that Hunter assisted the appellants in reporting on Parker to the IRS, thereby subjecting them to heightened scrutiny regarding their treatment of the joint venture income, "it is hard to understand how the Tax Court could have concluded that Hunter would have advised the appellants to take any position other than the one they adopted in this matter." *Streber,* —— F.3d at ——, Majority op. at 10. This analysis is problematic on two levels. First, the majority takes it upon itself to theorize about the cost-benefit of reporting to the IRS and thereby increasing their risks of an audit against the benefit of a potential cash reward analysis that the appellants conducted in weighing the cost for providing the IRS with what the majority acknowledges was information of "substantial value." *Id.* at ——, Majority op. at 11 n.9. Second, based on an assumption that Hunter provided the appellants with *sound* advice regarding the risks of heightened IRS scrutiny that would flow from reporting on Parker, the majority concludes that Hunter must have provided advice regarding the appropriate treatment of the joint venture income that, at least in the view of the appellants, was so *unsound* that it constituted legal malpractice.[15]

The majority also concludes that the tax court erred in drawing a negative inference from the fact that Hunter did not testify at the trial. In support of this conclusion, the majority states that, unless a potential witness has information "peculiarly within his knowledge," a party should feel free not to produce the potential witness " 'without any apprehension' that a court will draw a negative inference."

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[15] The appellants have filed a legal malpractice action against Hunter, the law firm where he is employed, and other attorneys related to Hunter's alleged advice that they treat the joint venture income as a gift for tax purposes.

Streber, —— F.3d at —. Majority op. at 13-14 (quoting *McKay v. Commissioner*, 886 F.2d 1237, 1238 (9th Cir. 1989), and John Henry Wigmore. Evidence § 287, at 202-03 (Chadbourn rev. 1979)). The legal authority that the majority cites for this proposition fails to bear it out.

First, *McKay* does not stand for the proposition that the trier of fact may draw a negative inference from a party's failure to produce a witness *only* when that witness possesses information peculiarly within his knowledge. The sentence containing the passage quoted by the majority states the following: "Moreover, petitioner declined to testify and since the fact at issue was peculiarly within his knowledge, the court properly concluded his testimony would be unfavorable to him. . . ." *McKay*, 886 F.2d at 1238. The most that one can glean from this passage is that the Ninth Circuit has concluded that a scenario in which a party declines to produce a witness to present testimony peculiarly within the witness's knowledge constitutes *one circumstance* in which the fact-finder may properly infer that the witness's testimony would be unfavorable to the party. In no sense does the Ninth Circuit's language preclude the existence of other such circumstances.

Second, Wigmore does not support the evidentiary rule advocated by the majority. In the passage cited by the majority, Wigmore states the general rule regarding when the trier of fact may draw negative inferences from a party's failure to produce a witness within his control as follows:

> [T]here is a general limitation (depending for its application on the facts of each case) that the inference [that a witness would testify in a manner unfavorable to the party that declines to produce him] cannot fairly be drawn except from the nonproduction of witnesses whose testimony would be *superior* in respect to the fact to be proved.

Wigmore, *supra*, § 287, at 203. One can hardly doubt that the testimony of Hunter—the purveyor of the legal advice at issue here—regarding the substance of that advice would have been in some sense superior to that of the witnesses who testified regarding the matter. Indeed, given the vague and conclusory nature of the testimony of the witnesses at trial regarding Hunter's advice and Tracy's substantial lapse of memory as to its substance, one might even conclude that the details of that advice were peculiarly within Hunter's knowledge.

More importantly, however, in the same paragraph quoted by the majority, Wigmore goes on to say that the general limitation on the fact-finder's authority to draw negative inferences from a party's failure to produce a witness rests on "grounds of expense and inconvenience" and "should not be enforced with any strictness; otherwise it would become practically objectionable." *Id.* In this case, the expense and inconvenience of placing Hunter on the witness stand would have been negligible. Not only was he available to the appellants, he was in the court room throughout the trial. Furthermore, the tax court found—and the appellants do not dispute—that the Tax Court Rules of Practice and Procedure would have allowed Hunter to testify without disqualification. *See* 26 U.S.C. foll. § 7453 R. 24(f).

The majority also contends that a conclusion that the tax court could properly draw a negative inference from Hunter's failure to testify "would in essence require the attorney to testify in all cases involving an advice of counsel defense." *Streber*, —— F.3d at ——, Majority op. at 15. This is simply not true. Allowing the tax court to draw such an inference does not imply that the testimony of counsel is *necessary* to establish a viable advice of counsel defense. It does not imply that the court *must* draw such an inference or that, when the court does draw such an inference, it is foreclosed from concluding that the other evidence in the record nonetheless establishes that the taxpayer reasonably relied on the advice of counsel.

In sum, given (1) the tax court's exclusive power to make credibility assessments regarding the witnesses at trial, (2) the paucity of evidence regarding what information Hunter had when he gave the advice at issue here, and (3) the tax court's discretion to draw a negative inference from Hunter's failure to testify, the tax court had ample basis on this factual record for concluding that the appellants did not bear their burden of proving that they were shielded from liability for negligence by good-faith reliance on the advice of counsel. As an appellate court, our inquiry properly ends there.

II. Substantial Understatement

The majority next errs in concluding that the tax court abused its discretion in holding the appellants liable for a substantial understatement penalty pursuant to former § 6661 of the Internal Revenue Code. Section 6661, repealed after the tax years at issue in this case, provided for the imposition of a penalty based on a taxpayer's substantial understatement of tax liability for a taxable year. *See* 26 U.S.C.A. § 6661(a) (West 1989) (repealed in 1989). The section provided that, for purposes of computing the penalty, the amount of the taxpayer's understatement of tax liability is "reduced by the portion of the understatement which is attributable to . . . the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment." *Id.* § 6661(b)(2)(B)(1). The taxpayer bears the burden of proving the existence of substantial authority. *See Westbrook*, 68 F.3d at 882.

The majority concludes that, from a factual standpoint, substantial authority for a taxpayer's position within the meaning of § 6661 exists unless "'there was a record upon which the Government could obtain a reversal under the clearly erroneous standard'" had the tax court accepted the taxpayer's position. *Streber*, —— F.3d at ——, Majority op. at 18 (quoting *Osteen v. Commissioner*, 62 F.3d 356, 359 (11th Cir. 1995)). This construction of

the substantial authority standard contravenes § 6661's interpretive regulations. Section 1.6661-3 of the Treasury Regulations indicates that § 6661's substantial authority standards does not contemplate substantial *evidentiary* authority. Rather, the regulation provides an exclusive list of potential sources of authority, all of which are *legal* sources, which indicates that § 6661 contemplates only substantial *legal* authority. Section 1.6661-3 provides in relevant part as follows:

> Types of authority. In determining whether there is substantial authority . . . , *only the following will be considered authority.* Applicable provisions of the Internal Revenue Code and other statutory provisions; temporary and final regulations construing such statutes; court cases; administrative pronouncements (including revenue rulings and revenue procedures); tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; and Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers.

26 C.F.R. § 1.6661-3(b)(2) (1997) (emphasis added). Noticeably absent from this list of potential sources of authority is any mention of factual evidence favorable to the taxpayer's position.

Furthermore, the majority's construction of the substantial authority standard implies that, in many circumstances, if a taxpayer is able to survive summary judgment, he is shielded from liability for substantial understatement penalties because substantial authority—in the form of some evidence—supports his tax position.[16]

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[16] It is true that "[a] finding is clearly erroneous when, although some evidence supports the decision, we are 'left with the definite and firm conviction that a mistake has been committed.'" *United States v. Teilo*, 9 F.3d 1119, 1122 (5th Cir.1993) (quoting *United*

Moreover, when a taxpayer's entitlement to a particular tax benefit hinges upon facts that will be elucidated by witness testimony, the taxpayer need only lie about the facts that would entitle him to the benefit in order to shield himself from liability for a substantial understatement penalty resulting from his improperly claiming the benefit. In such a circumstance, the taxpayer's testimony would constitute some evidence indicating his entitlement to the benefit, and the majority opinion in this case notwithstanding, it is doubtful that we would be in a position on appeal to conclude that the trial court would have clearly erred had it credited the taxpayer's testimony. Surely Congress did not intend to impose such a toothless penalty for substantial understatement of tax liability.[17]

The majority's erroneous construction of the substantial authority standard is rendered even more unfortunate by the fact that it is entirely gratuitous. The majority independently concludes that the IRS abused its discretion by declining to waive the substantial understatement penalty pursuant to § 6661(c) because the appellants relied in good faith on the advice of counsel in choosing to treat the joint venture income as a gift. As I indicated above

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States v. United States Gypsum Co., 333 U.S. 364, 395 (1948)). However, on numerous occasions, we have concluded that a factual finding is not clearly erroneous based on an inquiry that appears to begin and end with a determination that the record contains some evidence supporting the factual finding. *See, e.g., United States v. Jobe*, 101 F.3d 1046, 1066 (5th Cir. 1996); *Lewis v. NLRB*, 750 F.2d 1266, 1278-79 (5th Cir. 1985).

[17] It is worth noting that the majority's construction of the substantial authority standard also provides a disincentive for taxpayers to settle with the IRS in situations in which they are potentially liable for substantial understatement penalties. If the taxpayer is able to create a fact issue about which reasonable minds could differ regarding his entitlement to a particular tax benefit, he can avoid liability for substantial understatement penalties. In some circumstances, this heightened incentive may be sufficiently strong that it convinces the taxpayer to proceed to trial rather than settle the dispute.

in my discussion of the majority's treatment of the tax court's imposition of negligence penalties, the majority errs in this regard by making an independent assessment of the factual issue of whether the appellants truly acted in good-faith reliance on the advice of counsel. However, the majority's conclusion that the appellants were entitled to waiver of the penalty provides an independent, albeit legally unsound, basis for the decision to reverse the tax court's imposition of the substantial understatement penalty. Nevertheless, the majority proceeds to heap one legal error onto another by promulgating in dicta a construction of the substantial authority standard that fails to comport with the treasury regulations interpreting § 6661 and that robs the statute of much of its value as a deterrent of taxpayer misconduct. I therefore respectfully dissent.

APPENDIX B

Treasury Circular 230

§ 10.33 Tax shelter opinions.

(a) *Tax shelter opinions and offering materials.* A practitioner who provides a tax shelter opinion analyzing the Federal tax effects of a tax shelter investment shall comply with each of the following requirements:

(1) *Factual matters.* (i) The practitioner must make inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable and complete.

(ii) A practitioner may not accept as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client's statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.

(iii) If the fair market value of property or the expected financial performance of an investment is relevant to the tax shelter, a practitioner may not accept an appraisal or financial projection as support for the matters claimed therein unless:

(A) The appraisal or financial projection makes sense on its face;

(B) The practitioner reasonably believes that the person making the appraisal or financial projection is competent to do so and is not of dubious reputation; and

(C) The appraisal is based on the definition of fair market value prescribed under the relevant Federal tax provisions.

(iv) If the fair market vaue of purchased property is to be established by reference to its stated purchase price,

the practitioner "must examine" the terms and conditions upon which the property was (or is to be) purchased to determine whether the stated purchase price reasonably may be considered to be its fair market value.

(2) *Relate law to facts.* The practitioner must relate the law to the actual facts and, when addressing issues based on future activities, clearly identify what facts are assumed.

(3) *Identification of material issues.* The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues which involve the reasonable possibility of a challenge by the Internal Revenue Service have been fully and fairly addressed in the offering materials.

(4) *Opinion on each material issue.* Where possible, the practitioner must provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue presented by the offering which involves a reasonable possibility of a challenge by the Internal Revenue Service. Where such an opinion cannot be given with respect to any material tax issue, the opinion should fully describe the reasons for the practitioner's inability to opine as to the likely outcome.

(5) *Overall evaluation.* (i) Where possible, the practitioner must provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized. Where such an overall evaluation cannot be given, the opinion should fully describe the reasons for the practitioner's inability to make an overall evaluation. Opinions concluding that an overall evaluation cannot be provided will be given special scrutiny to determine if the stated reasons are adequate.

(ii) A favorable overall evaluation may not be rendered unless it is based on a conclusion that substantially more than half of the material tax benefits, in terms of their financial impact on a typical investor, more likely

than not will be realized if challenged by the Internal Revenue Service.

(iii) If it is not possible to give an overall evaluation, or if the overall evaluation is that the material tax benefits in the aggregate will not be realized, the fact that the practitioner's opinion does not constitute a favorable overall evaluation, or that it is an unfavorable overall evaluation, must be clearly and prominently disclosed in the offering materials.

(iv) The following examples illustrate the principles of this paragraph:

Example (1). A limited partnership acquires real property in a sale-leaseback transaction. The principal tax benefits offered to investing partners consist of depreciation and interest deductions. Lesser tax benefits are offered to investors by reason of several deductions under Internal Revenue Code section 162 (ordinary and necessary business expenses). If a practitioner concludes that it is more likely than not that the partnership will not be treated as the owner of the property for tax purposes (which is required to allow the interest and depreciation deductions), then he/she may not opine to the effect that it is more likely than not that the material tax benefits in the aggregate will be realized, regardless of whether favorable opinions may be given with respect to the deductions claimed under Code section 162.

Example (2). A corporation electing under subchapter S of the Internal Revenue Code is formed to engage in research and development activities. The offering materials forecast that deductions for research and experimental expenditures equal to 75% of the total investment in the corporation will be available during the first two years of the corporation's operations, other expenses will account for another 15% of the total investment, and that little or no gross income will be received by the corporation during this period. The practitioner concludes

that it is more likely than not that deductions for research and experimental expenditures will be allowable. The practitioner may render an opinion to the effect that based on this conclusion, it is more likely than not that the material tax benefits in the aggregate will be realized, regardless of whether he/she can opine that it is more likely than not that any of the other tax benefits will be achieved.

Example (3). An investment program is established to acquire offsetting positions in commodities contracts. The objective of the program is to close the loss positions in year one and to close the profit positions in year two. The principal tax benefit offered by the program is a loss in the first year, coupled with the deferral of offsetting gain until the following year. The practitioner concludes that the losses will not be deductible in year one. Accordingly, he/she may not render an opinion to the effect that it is more likely than not that the material tax benefits in the aggregate will be realized, regardless of the fact that he/she is of the opinion that losses not allowable in year one will be allowable in year two, because the principal tax benefit offered is a one-year deferral of income.

Example (4). A limited partnerhip is formed to acquire, own and operate residential rental real estate. The offering material forecasts gross income of $2,000,000 and total deductions of $10,000,000, resulting in net losses of $8,000,000 over the first six taxable years. Of the total deductions, depreciation and itnerest are projected to be $7,000,000, and other deductions $3,000,000. The practitioner concludes that it is more likely than not that all of the depreciation and interest deductions will be allowable, and that it is more likely than not that the other deductions will not be allowed. The practitioner may render an opinion to the effect that it is more likely than not that the material tax benefits in the aggregate will be realized.

(6) *Description of opinion.* The practitioner must assure that the offering materials correctly and fairly represent the nature and extent of the tax shelter opinion.

(b) *Reliance on other opinions*—(1) *In general.* A practitioner may provide an opinion on less than all of the material tax issues only if:

(i) At least one other competent practitioner provides an opinion on the likely outcome with respect to all of the other material tax issues which involve a reasonable possibility of challenge by the Internal Revenue Service, and an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized, which is disseminated in the same manner as the practitioner's opinion; and

(ii) The practitioner, upon reviewing such other opinions and any offering materials, has no reason to believe that the standards of paragraph (a) of this section have not been complied with.

Notwithstanding the foregoing, a practitioner who has not been retained to provide an overall evaluation whether the material tax benefits in the aggregate more likely than not will be realized may issue an opinion on less than all the material tax issues only if he/she has no reason to believe, based on his/her knowledge and experience, that the overall evaluation given by the practitioner who furnishes the overall evaluation is incorrect on its face.

(2) *Forecasts and projections.* A practitioner who is associated with forecasts or projections relating to or based upon the tax consequences of the tax shelter offering that are included in the offering materials, or are disseminated to potential investors other than the practitioner's clients, may rely on the opinion of another practitioner as to any or all material tax issues, provided that the practitioner who desires to rely on the other opinion has no reason to believe that the standards of paragraph (a) of this section have not been complied with by the practitioner

rendering such other opinion, and the requirements of paragraph (b)(1) of this section are satisfied. The practitioner's report shall disclose any material tax issue not covered by, or incorrectly opined upon, by the other opinion, and shall set forth his/her opinion with respect to each such issue in a manner that satisfies the requirements of paragraph (a) of this section.

(c) *Definitions.* For purposes of this section:

(1) *Practitioner* includes any individual described in § 10.3(e).

(2) A *tax shelter,* as the term is used in this section, is an investment which has as a significant and intended feature for Federal income or excise tax purposes either of the following attributes:

(i) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or

(ii) Credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. Excluded from the term are municipal bonds; annuities; family trusts (but not including schemes or arrangements that are marketed to the public other than in a (direct practitioner-client relationship); qualified retirement plans; individual retirement accounts; stock option plans; securities issued in a corporate reorganization; mineral development ventures, if the only tax benefit would be percentage depletion; and real estate where it is anticipated that in no year is it likely that deductions will exceed gross income from the investment in that year, or that tax credits will exceed the tax attributable to gross income from the investment in that year. Whether an investment is intended to have tax shelter features depends on the objective facts and circumstances of each case. Significant weight will be given to the features described in the offering materials to determine whether the investment is a tax shelter.

(3) A *tax shelter opinion,* as the term is used in this section, is advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials, or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice. The term includes the tax aspects or tax risks portion of the offering materials prepared by or at the direction of a practitioner, whether or not a separate opinion letter is issued or whether or not the practitioner's name is referred to in the offeing materials or in connection with the sales promotion efforts. In addition, a financial forcast or projection prepared by a practitioner is a tax shelter opinion if it is predicated on assumptions regarding Federal tax aspects of the investment, and it meets the other requirements of the first sentence of this paragraph. The term does not, however, include rendering advice solely to the offeror or reviewing parts of the offering materials, so long as neither the name of the practitioner, nor the fact that a practitioner has rendered advice concerning the tax aspects, is referred to in the offering materials or in connection with the sales promotion efforts.

(4) A material tax issue as the term is used in this section is

(i) Any Federal income or excise tax issue relating to a tax shelter that would make a significant contribution toward sheltering from Federal taxes income from other sources by providing deductions in excess of the income from the tax shelter investment in any year, or tax credits available to offset tax liabilities in excess of the tax attributable to the tax shelter investment in any year;

(ii) Any other Federal income or excise tax issue relating to a tax shelter that could have a significant impact (either beneficial or adverse) on a tax shelter investor under any reasonably foreseeable circumstances (e.g., depreciation or investment tax credit recapture, availability

of long-term capital gain treatment, or realization of taxable income in excess of cash flow, upon sale or other disposition of the tax shelter investment); and

(iii) The potential applicability of penalties, additions to tax, or interest charge that reasonably could be asserted against a tax shelter investor by the Internal Revenue Service with respect to the tax shelter. The determination of what is material is to be made in good faith by the practitioner, based on information available at the time the offering materials are circulated.

(d) For purposes of advising the Director of Practice whether an individual may have violated § 10.33, the Director of Practice is authorized to establish an Advisory Committee, composed of at least five individuals authorized to practice before the Internal Revenue Service. Under procedures established by the Director of Practice, such Advisory Committee shall, at the request of the Director of Practice, review and make recommendations with regard to alleged violations of § 10.33.

APPENDIX C

Special Trial Judge Wolfe of the Tax Court has thus far imposed the negligence penalty in 54 plastic recycling cases in all but one of the opinions to date. The cases include:

Merino v. Commissioner, T.C. Memo. 1997-385; *Singer v. Commissioner*, T.C. Memo. 1997-325; *Greene v. Commissioner*, T.C. Memo. 1997-296; *Kaliban v. Commissioner*, T.C. Memo. 1997-271; *Estate of Weber v. Commissioner*, T.C. Memo. 1997-271; *Zimmer v. Commissioner*, T.C. Memo. 1997-271; *Alter v. Commissioner*, T.C. Memo. 1996-558; *Friedman v. Commissioner*, T.C. Memo. 1996-558; *Becker v. Commissioner*, T.C. Memo. 1996-538; *Jaroff v. Commissioner*, T.C. Memo. 1996-527; *Fredericks v. Commissioner*, T.C. Memo. 1996-454; *Fishbach v. Commissioner*, T.C. Memo. 1996-454; *Gollin v. Commissioner*, T.C. Memo. 1996-454; *Morgan v. Commissioner*, T.C. Memo. 1996-399; *Grelsamer v. Commissioner*, T.C. Memo. 1996-399; *Selvin v. Commissioner*, T.C. Memo. 1996-398; *David v. Commissioner*, T.C. Memo. 1996-398; *Blount v. Commissioner*, T.C. Memo. 1996-398; *Zenkel v. Commissioner*, T.C. Memo. 1996-398; *Snyder v. Commissioner*, T.C. Memo. 1996-342; *Estate of Busch v. Commissioner*, T.C. Memo. 1996-342; *Farrell v. Commissioner*, T.C. Memo. 1996-341; *Spears v. Commissioner*, T.C. Memo. 1996-341, *Duboff v. Commissioner*, T.C. Summary Opinion 1996-103; *Cote v. Commissioner*, T.C. Memo. 1996-230; *Stone v. Commissioner*, T.C. Memo. 1996-230; *Philip Yarnell v. Commissioner*, T.C. Memo. 1996-84; *Marvin Yarnell v. Commissioner*, T.C. Memo. 1996-84; *Brodie v. Commissioner*, T.C. Memo. 1996-84; *Reimann v. Commissioner*, T.C. Memo. 1996-84; *Black v. Commissioner*, T.C. Memo. 1996-14; *Bennett v. Commissioner*, T.C. Memo. 1996-14; *Atkind v. Commissioner*, T.C. Memo. 1995-582; *Kravitz v. Commissioner*, T.C. Memo. 1995-581; *Cohn v. Commissioner*,

T.C. Memo. 1995-581; *Triemstra v. Commissioner*, T.C. Memo. 1995-581; *Berry v. Commissioner*, T.C. Memo. 1995-580; *Pace v. Commissioner*, T.C. Memo. 1995-580; *Dworkin v. Commissioner*, T.C. Memo. 1995-533; *Sorey v. Commissioner*, T.C. Memo. 1995-525; *Wilson v. Commissioner*, T.C. Memo. 1995-525; *Avellini v. Commissioner*, T.C. Memo. 1995-489; *Von Almen v. Commissioner*, T.C. Memo. 1995-387; *Paulson v. Commissioner*, T.C. Memo. 1995-387; *Lalmalani v. Commissioner*, T.C. Memo. 1995-346; *Ramesh v. Commissioner*, T.C. Memo. 1995-346; *Reister v. Commissioner*, T.C. Memo. 1995-305; *Fralich v. Commissioner*, T.C. Memo. 1995-257; *Shapiro v. Commissioner*, T.C. Memo. 1995-224; *Pierce v. Commissioner*, T.C. Memo. 1995-223; *Fine v. Commissioner*, T.C. Memo. 1995-222; *Pearlman v. Commissioner*, T.C. Memo. 1995-182; *Kott v. Commissioner*, T.C. Memo. 1995-181; and *Eisenberg v. Commissioner*, T.C. Memo. 1995-180.

In *Singer v. Commissioner*, T.C. Memo. 1997-325, *supra*, Special Trial Judge Wolfe found the taxpayer liable for the negligence penalty even though he had less than a high school education and relied on a trusted stockbroker in making the investment. In *Merino v. Commissioner*, T.C. Memo. 1997-385, *supra*, he likewise found a taxpayer negligent even though he was a plastics and oil pricing expert. Specifically, the taxpayer had advanced degrees in industrial engineering and managerial economics and worked for Celanese Corporation, a major producer of plastics, as manager of the hydrocarbon planning group. Prior to investing in the transaction, the taxpayer inspected the recycler and its operation ,and questioned Celanese technical personnel about Packaging Industries' reputation, the recycler, and other recycling machines.

The sole exception to the foregoing decisions was Judge Wolfe's consolidated opinion in *Zidanich v. Commissioner*, T.C. Memo. 1995-382, and *Steinberg v. Commissioner*,

T.C. Memō. 1995-382. There, he held that two women were not liable for the negligence penalty on the ground of what he characterized as "exceptional circumstances."